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In The Supreme Court of the United States

JOHNSON CONTROLS, INC.; SECURITY GROUP, INC. AND SUBSIDIARIES, INCLUDING SARGENT & GREENLEAF, INC.; WILLIS NORTH AMERICA, INC. AND AFFILIATES; BUNZL USA, INC. AND SUBSIDIARIES INCLUDING MAK-PAK, INC.; TREDEGAR CORPORATION, INC. AND SUBSIDIARIES; RAYCOM TV BROADCASTING, INC., AS SUCCESSOR-IN-INTEREST OF COSMOS BROADCASTING CORPORATION AND AFFILIATES, PETITIONERS,

v.

JONATHAN MILLER, SECRETARY OF THE FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY; COMMONWEALTH OF KENTUCKY, DEPARTMENT OF REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF KENTUCKY

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Under the Due Process Clause, a state may not deprive a taxpayer of "meaningful backward-looking relief" when the taxpayer has no predeprivation remedy for the overpayment of taxes, and tax legislation that is retroactive in effect cannot be without limitation. *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18 (1990); and *U.S. v. Carlton*, 512 U.S. 26 (1994). Additionally, under the Equal Protection Clause, similarly-situated taxpayers are entitled to uniform treatment. *Allied Stores of Ohio v. Bowers*, 358 U.S. 522 (1959). Nevertheless, the Kentucky General Assembly, in its 2000 regular session, amended Kentucky Revised Statute 141.200 to eliminate the post-deprivation remedy of a targeted group of taxpayers that had refund claims pending for tax years 1990-1994—a retroactive effect of six to ten years. The question presented is:

> Whether a state's interest in raising and controlling revenue gives the state an unfettered right to retroactively eliminate the post-deprivation remedy of a targeted group of taxpayers at the expense of their due process and equal protection rights.

PARTIES TO THE PROCEEDING

Parties to the proceeding are listed in the caption of the case.

RULE 29.6 STATEMENT

Pursuant to Supreme Court Rule 29.6, the Petitioners state as follows:

Johnson Controls, Inc. has neither a parent corporation nor any publicly held corporation that owns 10% or more of its stock. The stock of Johnson Controls, Inc. is publicly traded on the New York Stock Exchange.

Security Group, Inc. is a wholly-owned subsidiary of Stanley Security Solutions, Inc. Stanley Security Solutions, Inc. is part of The Stanley Works, the stock of which is publicly traded on the New York Stock Exchange.

Willis North America, Inc. is a wholly-owned subsidiary of Willis Group Limited (UK), and its ultimate parent corporation is Willis Group Holdings Public Limited Company (Ireland). The stock of Willis Group Holdings Public Limited Company is publicly traded on the New York Stock Exchange.

Bunzl USA, Inc., is a wholly-owned subsidiary of Bunzl plc. The stock of Bunzl plc is publicly traded on the London Stock Exchange.

RULE 29.6 STATEMENT – Continued

Tredegar Corporation has neither a parent corporation nor any publicly held corporation that owns 10% or more of its stock. The stock of Tredegar Corporation is publicly traded on the New York Stock Exchange.

Raycom TV Broadcasting, Inc. is a privately held corporation.

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PETITION FOR WRIT OF CERTIORARI

The Petitioners, Johnson Controls, Inc., Security Group, Inc. and Subsidiaries, including Sargent & Greenleaf, Inc.; Willis North America, Inc. and Affiliates; Bunzl USA, Inc. and Subsidiaries, including Mak-Pak, Inc.; Tredegar Corporation, Inc. and Subsidiaries; and Raycom TV Broadcasting, Inc., as successor-in-interest of Cosmos Broadcasting Corporation and Affiliates, respectfully petition for a writ of certiorari to review the opinion of the Supreme Court of Kentucky.

OPINIONS BELOW

The Supreme Court of Kentucky rendered its decision on August 27, 2009. The decision is reported at 296 S.W.3d 392 (Ky. 2009), and it is reprinted at Petitioners' Appendix (App.) 1-76. The court subsequently entered an order denying rehearing on November 25, 2009. This order is reported at 56 Ky. Law Summary (K.L.S.) 12, p. 110, and it is reprinted at App. 120-121.

The Court of Appeals of Kentucky rendered its decision on May 5, 2006. The decision is reported at 53 K.L.S. 5, p. 7, and it is reprinted at App. 77-101.

The Franklin Circuit Court, the court of first instance, entered its opinion and order on July 1, 2004. This opinion is unreported but reprinted at App. 102-119.

JURISDICTION

The opinion of the Supreme Court of Kentucky was rendered on August 27, 2009. The Petitioners' timely-filed petition for rehearing was denied on November 25, 2009. This Court has jurisdiction of this Petition under 28 USC § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The constitutional provisions involved are the Due Process and Equal Protection Clauses of the Fourteenth Amendment to the U.S. Constitution providing, in pertinent part: "[N]or shall any state deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws." U.S. CONST. amend. XIV.

The Kentucky statutory provisions involved are Kentucky Revised Statutes (KRS) §§ 141.200(9)-(10) (2000):

> (9) No claim for refund or credit of a tax overpayment for any taxable year either on or before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return shall be effective or recognized for any purpose.

> (10) No corporation or group of corporations shall be allowed to file a combined return under the unitary business concept or a consolidated return for any taxable year ending before December 31, 1995, unless on or before December 22, 1994, the corporation or group of corporations filed an initial or amended return under the unitary business concept or consolidated return for a taxable year ending before December 22, 1994.

STATEMENT OF THE CASE

A. Factual Background

The genesis of this case dates back to 1966, when the Kentucky General Assembly adopted the Uniform Division of Income for Tax Purposes Act (UDITPA). 1966 Ky. Acts, ch. 176, Part I, § 6. UDITPA, a uniform act adopted by numerous states, set forth, in pertinent part, a definition of "business income" and a means by which states could determine the corporation income tax liability of a multi-state corporation doing business within and outside of the state. From at least 1972 until 1988, the Kentucky Revenue Cabinet construed the statutory definition of "business income" to require multi-corporate groups that operated on a unitary basis to file combined income tax returns for the entire unitary group, rather than filing separate returns for each corporation within the group.

On November 27, 1988, the Kentucky Revenue Cabinet adopted Revenue Policy 41P225, which abrogated the policy of requiring unitary taxpayers to file

combined income tax returns. Revenue Policy 41P225 declared that combined income tax returns only would be accepted when a unitary group included a sham or shell corporation established to reduce the group's income tax obligation, and that all other corporations would be required to file separate income tax returns.

After the Kentucky Revenue Cabinet's adoption of Revenue Policy 41P225, a multi-corporate taxpayer, GTE and Subsidiaries, challenged the policy as being inconsistent with the statutory definition of "business income." At the time the challenge was brought and decided, KRS § 141.120(1)(a) defined "business income" to include "income arising from transactions and activity in the regular course of a trade or business of the taxpayer." GTE and Subsidiaries maintained that the term "taxpayer" from the statutory definition should be read to refer to all of the corporations within a unitary group, arguing that because of the interrelated nature of the corporations within a unitary group the "business income" of the group could not be determined through separate returns filed by each corporation within the group. On December 22, 1994, the Kentucky Supreme Court invalidated Revenue Policy 41P225 and recognized that Kentucky law required unitary groups to file combined income tax returns:

> [KRS 141.120] is based on the calculation of business income which cannot be determined on a separate return basis for members of a unitary group but which must be calculated

> on the combined unitary business for the group as a whole.

GTE and Subsidiaries v. Revenue Cabinet, 889 S.W.2d 788, 793 (Ky. 1994).

In the years that immediately followed the *GTE* decision, twenty-nine taxpayers, including the six Petitioners, filed amended income tax returns for the years prior to the *GTE* decision, with the tax years at issue primarily being 1990 through 1994. These amended returns were based upon a change from the separate returns previously required by Revenue Policy 41P225 to the combined returns required by *GTE*, and all sought refunds of overpaid income tax.

The income tax refund claims involved a significant amount of money. The estimated total amount of the twenty-nine claims, before interest, is approximately $106,000,000, with the refund claims filed by the Petitioners totaling approximately $5,500,000. While the Kentucky Revenue Cabinet processed a limited number of the refund claims and refunded income tax overpayments to seven unitary groups, no substantive administrative action was taken on the majority of the refund claims prior to 2000.

During the 2000 Regular Session of the Kentucky General Assembly, KRS § 141.200 was amended to deprive the limited group of unitary taxpayers, including the Petitioners, of their right to pursue the refund claims. The General Assembly effected this deprivation through two substantive amendments.

The first amendment simply declared that the refund claims at issue would not be honored:

> No claim for refund or credit of a tax overpayment for any taxable year either on or before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return shall be effective or recognized for any purpose.

KRS § 141.200(9) (2000). The second amendment retroactively precluded unitary taxpayers, including the Petitioners, from filing combined income tax returns that produced refund claims:

> No corporation or group of corporations shall be allowed to file a combined return under the unitary business concept or a consolidated return for any taxable year ending before December 31, 1995, unless on or before December 22, 1994, the corporation or group of corporations filed an initial or amended return under the unitary business concept or consolidated return for a taxable year ending before December 22, 1994.

KRS § 141.200(10) (2000).[1] The Petitioners challenged the validity of these amendments on state and federal constitutional grounds.

B. Proceedings Below

The Petitioners raised and litigated a number of state and federal constitutional challenges to the 2000 Amendments. However, only the challenges brought under the Due Process Clause and Equal Protection Clause of the Fourteenth Amendment to the United States Constitution are pertinent to this proceeding. The Petitioners raised two arguments under the Due Process Clause: (1) The extinguishment of the Petitioners' right to pursue pending income tax refund claims violates the due process guarantee of "meaningful backward-looking relief" for overpaid taxes recognized by this Court in *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18 (1990); and (2) No legitimate legislative purpose supports the legislation and the six to ten year period of retroactivity is unconstitutionally excessive under this Court's decision in *U.S. v. Carlton*, 512 U.S. 26 (1994). In their Equal Protection Clause argument, the Petitioners maintained that the 2000

---

[1] House Bill 541, 2000 Ky. Acts ch. 543, was the means through which the General Assembly amended KRS § 141.200. Section 3 of House Bill 541 provides that the amendments "shall apply retroactively for all taxable years ending before December 31, 1995." The relevant provisions of House Bill 541 are reprinted in at App. 122-124. KRS §§ 141.200(9)-(10) (2000) will be referred to as the "2000 Amendments" throughout this Petition.

Amendments should be invalidated because they create a classification that treated similarly-situated taxpayers differently based solely on two arbitrary criteria: (1) whether the taxpayers filed their income tax refund claims before or after the date of the Supreme Court of Kentucky's decision in *GTE*; and (2) whether the Kentucky Revenue Cabinet processed the particular refund claims prior to the enactment of the 2000 Amendments.

The Franklin Circuit Court, the state trial court in which the Petitioners first challenged the constitutionality of the 2000 Amendments, disposed of the action on summary judgment. *See* App. 102-119. The court rejected the due process and equal protection arguments raised by the Petitioners and upheld the constitutionality of the 2000 Amendments. *Id.* at 108, 111 and 114. The Court of Appeals reversed on the grounds that the period of retroactivity effected by the 2000 Amendments is excessive in violation of the Petitioners' due process rights under this Court's decision in *Carlton*, 512 U.S. 26. App. at 95-96. The Court of Appeals also recognized that the Petitioners are entitled to "meaningful backward-looking relief" for their overpaid income taxes under this Court's decision in *McKesson*, 496 U.S. 18. App. at 97. While reversing the Franklin Circuit Court's decision on due process grounds, the Court of Appeals agreed with the lower court's determination that the 2000 Amendments do not violate the Petitioners' equal protection rights. *Id.* at 98.

The Commonwealth sought and obtained discretionary review from the Kentucky Supreme Court, which rejected the due process and equal protection arguments raised by the Petitioners and affirmed the constitutionality of the 2000 Amendments. Addressing the Petitioners' due process arguments, the court found that the 2000 Amendments are rationally related to the legitimate governmental purpose of "raising and controlling revenue" and that the period of retroactivity is not constitutionally excessive because the General Assembly acted "[a]t the first reasonable opportunity, as it became aware of the issues . . . " 296 S.W.3d at 400-401, App. at 21. The court further found that the "meaningful backward-looking relief" requirement from *McKesson* does not apply in this case because the refund claims at issue are not premised on overpayments made as a result of "an *unconstitutional* application of a tax." *Id.* at 402, App. at 24 (emphasis in original). The court summarily disposed of the equal protection issue on a finding that a legitimate governmental purpose supports the 2000 Amendments and the means employed to accomplish that purpose are rationally related to the purpose. *Id.* at 403, App. at 27.

REASONS FOR GRANTING THE PETITION

In this case, the Kentucky Supreme Court has decided important federal questions in direct contravention of the decisions of this Court. These important questions have broad ramifications for the tension that exists between a state's interest in raising and controlling revenue and a taxpayer's

constitutional rights to due process and equal protection. This tension is especially acute here as the legislative enactment selected by the Kentucky General Assembly to effectuate the interest in raising and controlling revenue has the effect of retroactively depriving a targeted group of taxpayers of the right to pursue income tax refund claims, and in so doing denies the taxpayers rights and opportunities afforded to other similarly-situated taxpayers.

This tension between a state's interest in raising and controlling revenue and a taxpayer's due process and equal protection rights is particularly important now as numerous states face continuous revenue shortfalls and aggressively look to alternative sources for necessary funds. Under the auspices of the necessity of raising and controlling revenue, states have enacted laws and enforced policies that retroactively subject taxpayers to additional taxes or deprive taxpayers of the right to pursue refund claims to recover overpaid taxes. Two such cases are currently before this Court on petitions for certiorari. *See Triple-S Management, Corp. v. Municipal Revenue Collection Center*, No. KLAN200701749 and No. KLAN200800249 slip op. (P.R. July 17, 2008) (unpublished), *request for cert. denied* (P.R.S.C. March 16, 2009) and *motion for reconsideration denied* (P.R.S.C. April 28, 2009), and *second motion for reconsideration denied* (P.R.S.C. May 27, 2009), *petition for cert. filed*, 78 U.S.L.W. 8, p. 3099 (U.S. August 25, 2009) (No. 09-233) (Puerto Rico Supreme Court upheld administrative action by the Municipal Revenue Collection Center to

retroactively impose property taxes for a period of fifteen years); *Exelon Corporation v. Illinois Department of Revenue*, No. 105582 slip op. (Ill. Feb. 20, 2009) (unpublished), *modified upon denial of rehearing*, slip op. (Ill. July 15, 2009) (unpublished), *petition for cert. filed*, 78 U.S.L.W. 25, p. 3396 (U.S. December 22, 2009) (No. 09-759) (Illinois Supreme Court determined taxpayer entitled to a contested state tax credit, but limited taxpayer to prospective relief from the date of the decision).

The trend is clear—every branch of state government has become increasingly willing to justify the imposition of retroactive tax obligations and the confiscation of tax refunds and credits as necessary to raise and control revenue. This Court should accept certiorari to establish that a state's interest in raising and controlling revenue has limits and is not a carte blanche justification for the deprivation of rights guaranteed to taxpayers under the Fourteenth Amendment to the United States Constitution.

A. This Court Should Clarify That The Due Process Guarantee Of "Meaningful Backward-Looking Relief" Applies To Taxes Collected Under An Unlawful Application Of Law And Is Not Limited To Taxes Collected Under Unconstitutional Provisions.

This Court has held that an exaction of a tax is a deprivation of property, and due process requires a state to provide procedural safeguards sufficient to ensure that the state collects only the amount of tax

to which it is legally entitled. *McKesson*, 496 U.S. 18, 36. A state may offer these procedural safeguards either in the form of predeprivation relief—*i.e.*, a taxpayer is authorized to challenge its tax obligation prior to paying the tax—or in the form of post-deprivation relief—*i.e.*, a taxpayer is compelled to "pay first, litigate later." *Id.* at 36. When a state deprives a taxpayer of a meaningful predeprivation remedy, due process requires the state to provide post-deprivation relief. *Id.* at 31.

The Kentucky Supreme Court has determined that Kentucky's statutory tax provisions do not provide taxpayers with predeprivation relief for the overpayment of taxes because they are "pointedly designed to coerce taxpayers into remitting taxes before challenging any liability to avoid potential economic disadvantage." *Revenue Cabinet v. Gossum*, 887 S.W.2d 329, 333 (Ky. 1994). It follows from *McKesson* and *Gossum* that due process requires Kentucky to offer taxpayers a meaningful post-deprivation remedy. *Id.* at 332 (*citing McKesson*, 496 U.S. at 31). To satisfy this due process requirement, Kentucky must not only provide a taxpayer with a fair opportunity to challenge the accuracy and legal validity of its tax obligation, but also must offer a clear and certain remedy for the overpayment of taxes. *McKesson*, 496 U.S. at 39. Kentucky satisfies this due process obligation through statutory refund provisions, two of which apply to overpaid corporate income taxes: (1) KRS § 141.235, the specific income tax refund statute; and (2) KRS § 134.580, the general tax

refund statute. Kentucky's preference for a post-deprivation remedy is consistent with that of other states, and the remedy favored by the states has been to enact tax refund statutes allowing taxpayers to seek refunds of allegedly overpaid taxes after those taxes are paid. *See Reich v. Collins*, 513 U.S. 106, 112 (1994).

Having overpaid corporate income taxes on a separate return basis as required by the invalidated Revenue Policy 41P225, the Petitioners possessed a due process right to pursue refund claims for those overpaid taxes on the basis that their income should have been calculated on a combined basis for the unitary group as a whole. The 2000 Amendments deprive the Petitioners of this due process right by precluding the Petitioners from pursuing their refund claims. By effecting this deprivation, the 2000 Amendments employ the very "bait and switch" tactic condemned as unconstitutional by this Court in *Reich v. Collins*, 513 U.S. 106. *See also, Newsweek, Inc. v. Florida Department of Revenue*, 522 U.S. 442, 444-445 (1998) (vacating the decision of a Florida appellate court that had upheld the Department of Revenue's attempt to "cut off" the postpayment refund process on which Newsweek had relied because a predeprivation remedy existed). In its discussion of Georgia's decision to eliminate its previously-available, post-deprivation refund remedy for certain taxpayers, this Court offered the following analysis:

> [W]hat a State may *not* do, and what Georgia did here, is to reconfigure its scheme,

> unfairly, in *mid-course*—to "bait and switch," as some have described it. Specifically, in the mid-1980's, Georgia held out what plainly appeared to be a "clear and certain" postdeprivation remedy, in the form of its tax refund statute, and then declared, only after [the taxpayer] and others had paid the disputed taxes, that no such remedy exists. . . .
>
> Nor can there be any question that, during the 1980's . . . Georgia did appear to hold out a "clear and certain" postdeprivation remedy. To recall, the Georgia refund statute says that the State "*shall*" refund "*any and all* taxes or fees which are determined to have been erroneously or *illegally assessed* and collected from [a taxpayer] under the laws of the state, whether paid voluntarily or involuntarily."

Id. (emphasis in original). This is precisely what has happened with the Petitioners in this case. At the time the Petitioners filed their separate income tax returns pursuant to Revenue Policy 41P225, Kentucky held out a "clear and certain" post-deprivation remedy in the form of its refund statutes. It was only several years after the Petitioners filed their refund claims based on the Kentucky Supreme Court's ruling in *GTE* that the General Assembly enacted the 2000 Amendments, which retroactively precluded the Petitioners from pursuing any post-deprivation remedy to recover their corporate income tax overpayments.

The Kentucky Supreme Court rejected the Petitioners' argument that they possessed a due process right to pursue their refund claims under this Court's decisions in *McKesson* and *Reich*. In addressing the issue, the Kentucky Supreme Court determined that such a right only exists when a taxpayer alleges a refund is owed for taxes collected by a state in violation of the constitution:

> It is important to note that the Supreme Court made its ruling in *McKesson* premised upon a refund being due for an unconstitutional application of a tax, which naturally impacts federal due process. However, this Court in *GTE* did not make a constitutional declaration, but instead merely interpreted a constitutional statute. . . . Since constitutionality was not involved, the analysis then goes from deprivation of property without due process of law to the well-established analysis of when and how the government may enact economic legislation, specifically revenue-controlling legislation, under the *Carlton* line of cases.

296 S.W.3d at 402. The Kentucky Supreme Court's limitation of the due process guarantees recognized in *McKesson* and *Reich* to instances in which taxpayers seek refunds of taxes paid under unconstitutional laws is inconsistent with this Court's pronouncement on the issue, a pronouncement that is sufficiently clear for other jurisdictions that have considered the question to have followed uniformly.

In addressing the Petitioners' due process argument, the Kentucky Supreme Court articulated its understanding that this Court's decision in *McKesson* was "premised upon a refund being due for an unconstitutional application of a tax." *Id.* While there is a limited textual basis for the court's reading of *McKesson*,[2] the more complete reading establishes that this Court did not intend for its decision to be construed so narrowly. The best example of the Court's intention in *McKesson* is found in the following statement:

> To satisfy the requirements of the Due Process Clause, therefore, in this refund action the State must provide taxpayers with, not only a fair opportunity to challenge the accuracy and legal validity of their tax obligation, but also a clear and certain remedy for *any erroneous or unlawful tax collection* to ensure that the opportunity to contest the tax is a meaningful one.

496 U.S. at 39 (internal quotations and citations omitted, emphasis added). This statement shows that

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[2] Specifically, the following language appears in this Court's opinion: "Our precedent establishes that, if a State penalizes taxpayers for failure to remit their taxes in a timely fashion, thus requiring them to pay first and obtain review of the tax's validity later in a refund action, the Due Process Clause requires the State to afford the taxpayers a meaningful opportunity to secure postpayment relief for taxes already paid pursuant to a tax scheme ultimately held unconstitutional." 496 U.S. at 22.

this Court intended for *McKesson's* guarantee of "meaningful backward-looking relief" to apply to all refund claims involving "erroneous or unlawful tax collection" and not just to unconstitutional tax collection. This conclusion is logical as there is no reasonable basis for distinguishing between the remedies available to taxpayers that have paid unconstitutional taxes and those that have paid taxes that are otherwise unlawful. In both instances, the taxpayer has made payments to a state that were not owed and due process demands that the taxpayer be afforded an opportunity to have those payments refunded.

Numerous other jurisdictions that have considered this question have properly followed this Court's determination that due process guarantees "meaningful backward-looking relief" to all taxpayers who have paid taxes under unlawful provisions, and not just those that have paid under unconstitutional provisions. In *O'Connell Management Company, Inc. v. Massachusetts Port Authority*, 744 F.Supp. 368 (D. Mass. 1990), a federal district court rejected a state's invitation to limit the application of *McKesson* to refund claims involving taxes paid under unconstitutional statutes:

> [The State] argues that *McKesson* only applies to deprivations which violate the Constitution. "Congress—and Congress alone—must establish the appropriate relief from any violation of a *statutory* provision." [The State's] construction of *McKesson* is too narrow. The cases from which the Court

> derived its conclusion that postdeprivation remedies are constitutionally mandated involved violations of both constitutional and statutory law . . . I do not believe that the Supreme Court recognizes a substantive distinction between constitutional and statutory violations in this context.

Id. at 378; *see also, California State Outdoor Advertising Association, Inc. v. State of California*, 2006 U.S. Dist. LEXIS 11174 (E.D. Ca. March 2, 2006) (application of *McKesson* when permit fee paid pursuant to a regulation subsequently determined to be void for failure to comply with the Administrative Procedures Act). Similar decisions have been reached by other state courts that have considered the scope of *McKesson's* applicability. *See, e.g., City of Houston v. Harris County Outdoor Advertising Association*, 879 S.W.2d 322, 334 (Tex. App. 1994) ("The Due Process Clause applies to any *unlawful collection* of taxes, including one that violates state law or provisions of the state constitution.") (emphasis in original).

The Kentucky Supreme Court's decision to limit the due process guarantees of *McKesson* to taxpayers who have paid taxes under a law subsequently determined to be unconstitutional is in direct conflict with this Court's determination that no such limitation exists. This Court should grant certiorari to clarify that the applicability of the Due Process Clause is not so limited, and that the guarantee of "meaningful backward-looking relief' is available to remedy the

unlawful or erroneous collection of taxes as well as the unconstitutional collection of taxes.

B. This Court Should Clarify That The Due Process Clause Prohibits A State From Enacting Legislation With A Period Of Retroactivity Of Six To Ten Years, And In So Doing Offer Guidance To States And Taxpayers On The Due Process Limits Of Retroactive Legislation.

While this Court "repeatedly has upheld retroactive tax legislation against a due process challenge," *Carlton*, 512 U.S. at 30 (citations omitted), it has also acknowledged that retroactive application of a law is not without limits and cannot be "so harsh and oppressive as to transgress the constitutional limitation." *Welch v. Henry*, 305 U.S. 134, 147 (1938). In *Carlton*, this Court addressed the test that should apply when a taxpayer raises a due process challenge to retroactive tax legislation:

> "Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches. . . .
>
> "To be sure, . . . retroactive legislation does have to meet a burden not faced by legislation that has only future effects. . . . 'The retroactive aspects of the legislation, as well as the prospective aspects, must meet

> the test of due process, and the justifications for the latter may not suffice for the former'. . . . But that burden is met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose.

Carlton, 512 U.S. at 30-31 (internal quotations omitted). While this Court has refrained from identifying an absolute standard beyond which retroactivity periods will run afoul of due process—*e.g.*, tax legislation with a period of retroactivity longer than one year—this Court has considered "a modest period of retroactivity" as a factor that supports the constitutionality of retroactive legislation. *Id.* at 32. In her concurring opinion in *Carlton*, Justice O'Connor expounded in greater detail on this notion of modesty and the extent to which it factors into this Court's decisions on the constitutionality of retroactive tax legislation:

> In every case in which we have upheld a retroactive federal tax statute against due process challenge, however, the law applied retroactively for only a relatively short period prior to enactment. In *Welch v. Henry*, the tax was enacted in 1935 to reach transactions completed in 1933; but we emphasized that the state legislature met only biannually and it made the revision "at the first opportunity after the tax year in which the income was received." A period of retroactivity longer than the year preceding the legislative session in which the law was

> enacted would raise, in my view, serious constitutional problems.

Id. at 38 (O'Connor, J., concurring).

Lower courts have followed this Court's determination in *Carlton* in different ways. Some courts have read *Carlton* as imposing a "modesty" requirement for retroactive legislation and have followed Justice O'Connor's pronouncements in concluding that due process is violated by a period of retroactivity longer than the year preceding the legislative session in which the law was enacted. *See, e.g., Rivers v. State*, 490 S.E.2d 261, 265 (S.C. 1997) (recognizing a period of retroactivity must be "modest" and finding that a three-year period of retroactivity violated due process); *Estate of Edward Kunze v. Commissioner of Internal Revenue*, 233 F.3d 948, 954 (7th Cir. 2000) (recognizing that "the period of retroactivity must be moderate" and upholding a curative statute with a period of retroactivity of only eleven months); *City of Modesto v. National Med., Inc.*, 128 Cal. App. 4th 518, 528-29 (Ca. App. 2005) (stating that "the legislative body must act promptly and establish only a moderate period of retroactivity" and invalidating retroactive legislation that applied to tax years four to eight years preceding the legislative session that produced the legislation). Other courts have rejected the notion that the "modesty" of retroactive tax legislation should be considered as a separate factor independent of the due process standard identified by this Court in *Carlton*. *See, e.g., United States v. Atlantic Richfield Company*, 1996 U.S. Dist. LEXIS

22886, *30-31 (D. Mo. 1996) (finding that *Carlton* simply considered "modesty" in its analysis and did not set forth a "modesty" requirement that all retroactive tax legislation must meet to satisfy due process). These courts generally have refused to follow Justice O'Connor's position that serious constitutional problems arise when state legislatures adopt periods of retroactivity that extend back longer than the year preceding the legislative session that produced the legislation. *See, e.g., Montana Rail Link v. United States*, 76 F.3d 991, 994 (9th Cir. 1996) (determining that limiting legislation to "a one or two year period of retroactivity . . . would have been arbitrary and irrational"); *Licari v. Commissioner*, 946 F.2d 690 (9th Cir. 1991) (upholding a tax penalty enacted in 1986 with retroactive effect to tax returns filed from 1982 through 1984); *Rocanova v. United States*, 955 F.Supp. 27 (S.D.N.Y. 1996) (upholding legislation that extended the statute of limitations on tax collection actions from six to ten years), *aff'd per curiam*, 109 F.3d 127 (2d Cir. 1997).

The Kentucky Supreme Court has adopted a reading of *Carlton* that recognizes a role for a "modesty" requirement, but that rejects the notion that due process imposes an absolute temporal limitation on the extent to which tax legislation may be applied retroactively:

> Retroactive application of a statute need only be (1) supported by a legitimate legislative purpose (2) furthered by rational means,

> which includes an appropriate modesty requirement. This requires analysis of the facts and circumstances of each case, rather than applying a specified modesty period. The pertinent question is whether the period of retroactivity is one that makes sense in supporting the legitimate governmental purpose (rationally related).

296 S.W.3d at 399. The Kentucky Supreme Court applied this standard in upholding the constitutionality of the 2000 Amendments, which retroactively applied to tax years between 1990 and 1994 and precluded the Petitioners from pursuing refund claims that had been pending as far back as 1995. Indeed, the 2000 Regular Session of the General Assembly, in which the 2000 Amendments were enacted, was the third such legislative session following the filing of the majority of the refund claims at issue in this case.[3]

It should matter little whether courts consider the modesty requirement as a test that must be

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[3] The Kentucky Supreme Court determined that the General Assembly enacted the 2000 Amendments "[a]t the first reasonable opportunity, as it became aware of the issues. . . ." 296 S.W.3d at 401. There is no factual basis for this determination and the undisputed evidence before the Franklin Circuit Court on the parties' summary judgment motions established that the General Assembly was aware of the refund claims, and the amount of money at issue in those refund claims, before the 1996 Regular Session.

satisfied independent of the standard announced by this Court in *Carlton* or as factor to be considered within the determination of whether the period of retroactivity is "supported by a legitimate legislative purpose furthered by rational means." *Carlton*, 512 U.S. 31. The outcome should be the same under both approaches when the tax legislation being considered applies retroactively to a period of more than one year preceding the legislative session in which the legislation is enacted, as due process should limit state legislatures to enacting retroactive legislation only at the first opportunity to do so. It is fundamentally irrational for a state legislature to understand that a revenue or tax problem exists that can only be remedied through retroactive legislation, and fail to enact the necessary legislation at the first possible legislative session. This Court should grant certiorari to clarify the role that "modesty" plays in a due process challenge to retroactive legislation, and to establish that retroactive legislation violates due process when a state legislature fails to enact the legislation at the first possible legislative session.

C. This Court Should Establish That Equal Protection Precludes A State From Treating Similarly-Situated Taxpayers Differently Based Solely On The Date The Taxpayers Filed Income Tax Refund Claims And The Order In Which Those Claims Were Processed By A State Agency.

This Court has long recognized that a state has "broad powers to impose and collect taxes," *Allegheny Pittsburgh Coal Company v. County Commission of Webster County, West Virginia*, 488 U.S. 336, 344 (1989), and to establish classifications between and among various taxpayers. *See Brown-Forman Co. v. Kentucky*, 217 U.S. 563, 573 (1910). While these classifications are often permissible, this Court recognizes that the Fourteenth Amendment's Equal Protection Clause does impose a limit on the exercise of a state's authority:

> [There] is a point beyond which the State cannot go without violating the Equal Protection Clause. The State must proceed upon a rational basis and may not resort to a classification that is palpably arbitrary. The rule has often been stated to be that the classification 'must rest upon some ground of difference having a fair and substantial relation to the object of the legislation.'

Allied Stores of Ohio v. Bowers, 358 U.S. 522, 527 (1959). Stated otherwise, a tax law that creates a classification between taxpayers cannot withstand an equal protection challenge if the classification drawn

by the state is merely illusory. *F.S. Royster Guano Co. v. Virginia*, 253 U.S. 412, 415 (1920). While instances of this Court invalidating state tax classifications on equal protections grounds are few, such action has been taken when it has been clear that similarly-situated taxpayers have been treated differently as a result of a state law or administrative policy. *See, e.g., Allegheny*, 488 U.S. at 346 (holding that property owners were denied equal protection of the law when they were taxed on the fair value of their property, and other similarly-situated property owners enjoyed the tax benefits of having their property under-valued).

This case involves similarly-situated taxpayers being treated differently as a result of the 2000 Amendments. There was only one class of taxpayers affected by the Kentucky Supreme Court's decision in *GTE*—multi-corporate groups that operated on a unitary basis. Equal protection requires that each member of this class of taxpayers be treated similarly for corporate income tax purposes, but the enactment of the 2000 Amendments had the effect of dividing this single class into four subclasses:

> (1) Taxpayers that did not comply with Revenue Policy 41P225, but filed combined returns prior to *GTE* and were allowed by the state to benefit from this filing method;
>
> (2) Taxpayers that complied with Revenue Policy 41P225, but who filed amended combined returns after *GTE* and obtained

> refunds during the period between *GTE* and the enactment of the 2000 Amendments;
>
> (3) Taxpayers that complied with Revenue Policy 41P225, but that filed amended combined returns after *GTE* and obtained refunds after, and despite, the enactment of the 2000 Amendments; and
>
> (4) Taxpayers, including the Petitioners, that complied with Revenue Policy 41P225, and filed amended combined returns after *GTE*, but were not able to pursue refunds because no administrative action was taken on their claims until after the enactment of the 2000 Amendments.

The 2000 Amendments single out only this last subclass of taxpayers that filed income tax refund claims after the Kentucky Supreme Court's decision in *GTE*, and whose claims were not processed by the Kentucky Revenue Cabinet before the enactment of the 2000 Amendments. This limited subclass of taxpayers have been deprived of the opportunity to pursue their income tax refund claims, while other similarly-situated taxpayers faced no such deprivation. There is no question that the 2000 Amendments treated this subclass of taxpayers, including the Petitioners, differently than similarly-situated taxpayers who were permitted to file on a combined basis prior to *GTE* or subsequently pursue their income tax refund claims. The only issue for equal protection purposes is whether this disparate treatment is supported by a rational basis.

The Kentucky Supreme Court dismissed the Petitioners' equal protection arguments perfunctorily:

> [S]tatutes or practices that have the effect of distinguishing between entities solely on an economic basis are "presumed to be valid and . . . generally comply with federal equal protection requirements if the classifications that they create are rationally related to a legitimate state interest." The analysis is the same under the Kentucky Constitution. This "rational basis" test is the same as required under due process for economic legislation, and, as discussed above, the 2000 amendments to the tax statute clearly satisfy it.

296 S.W.3d at 403 (internal citations omitted). The "legitimate state interest" identified by the Kentucky Supreme Court was "raising and controlling revenue" and the prevention of an alleged "significant and unanticipated revenue loss." *Id.* at 400.

While "raising and controlling revenue" and the prevention of "a significant and unanticipated revenue loss" undoubtedly serve as a rational basis for certain state legislation, these considerations do not offer ample justification for depriving the Petitioners of the right to pursue their income tax refund claims, a right enjoyed by other similarly-situated taxpayers. This Court should take the opportunity presented by the unique facts of this case—*i.e.*, a class of similarly-situated corporate taxpayers divided by state legislation that deprives certain of the taxpayers of the right to pursue refund claims based on the filing of

combined returns, a right afforded to other members of the class—to remind legislators and regulators alike that equal protection *does* preclude states from enacting discriminatory tax legislation. This Court should serve notice to the states that they will not be permitted to address purported revenue needs by enacting legislation that targets a specific group of taxpayers for discriminatory treatment.

At least one state court has concluded that a state cannot justify the elimination of refund procedures for a select group of taxpayers on the grounds of preservation of state revenue. In *Armco Steel Corp. v. Department of Treasury, Corp. Franchise Fee Div.*, 358 N.W.2d 839 (Mich. 1984), the Michigan Supreme Court invalidated a statute strikingly similar to the 2000 Amendments in its effect. The Michigan legislature confiscated certain refund claims brought by taxpayers that made payments following audits subsequently determined to be unauthorized. The state attempted to justify the confiscation by arguing that it would suffer a large potential revenue loss if required to grant the refunds. The court rejected this justification, finding that there was no rational basis supporting the disparate treatment between those taxpayers that made payments and subsequently sought refunds and those that refused to make the payments in the first instance. The court specifically held that the time of filing a refund claim is not a natural distinguishing characteristic upon which a classification of similarly-situated taxpayers may be based. *Id.* at 841-43.

A similar set of facts is presented in this case. The Petitioners complied with Revenue Policy 41P225 and have been denied the opportunity to pursue refunds of the taxes they would not have paid if permitted to file combined returns, while similarly-situated taxpayers that disregarded Revenue Policy 41P225 have enjoyed the benefits of combined filing. This is the result intended and carried out by the 2000 Amendments. This Court should grant certiorari to emphasize that the Equal Protection Clause still has viability in the context of tax legislation, and that states will not be able to address their revenue shortfalls by discriminating against targeted groups of taxpayers.

CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be granted.

Respectfully submitted,

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Supreme Court of Kentucky

2006-SC-000416-DG
2007-SC-000819-DG

JONATHAN MILLER, SECRETARY OF THE FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY; COMMONWEALTH OF KENTUCKY, DEPARTMENT OF REVENUE, APPELLANTS/CROSS-APPELLEES,

v.

ON REVIEW FROM
COURT OF APPEALS
CASE NO. 2004-CA-001566-MR
FRANKLIN CIRCUIT COURT
NOS. 00-CI-00523 AND 00-CI-00661

JOHNSON CONTROLS, INC.; SECURITY GROUP, INC. AND SUBSIDIARIES, INCLUDING SARGENT & GREENLEAF, INC.; WILLIS NORTH AMERICA, INC. AND AFFILIATES; BUNZL USA, INC. AND SUBSIDIARIES INCLUDING MAK-PAK, INC.; TREDEGAR CORPORATION, INC. AND SUBSIDIARIES; COSMOS BROADCASTING CORPORATION AND AFFILIATES, APPELLEES/CROSS-APPELLANTS.

OPINION OF THE COURT
BY JUSTICE NOBLE

REVERSING

This appeal addresses the constitutionality and application of certain amendments to the corporate tax statutes passed by the General Assembly in 2000 that barred the filing of combined tax returns under the unitary business concept and the issuance of tax refunds related to such a filing, even if by amended return, for the years prior to 1995. The Appellants (and Cross-Appellees) Jonathan Miller, et al., collectively on behalf of the Commonwealth of Kentucky, assert that the amended tax statutes satisfy all constitutional requirements, and that they were economic legislation enacted for a legitimate purpose, even though they disallow filing combined returns or collecting a refund thereon for the years before 1995. The Appellants also argue that the legislature effectively withdrew its consent to be sued for such refunds. Appellees (and Cross-Appellants) Johnson Controls, et al., argue that their due process rights will be violated if the 2000 amendments to the tax statutes are allowed to prevent them from getting a refund. They also claim denial of equal protection under the law and violation of other Kentucky Constitutional rights. Because we find that the tax statute amendments were enacted for the legitimate governmental purpose of regulating revenue, and that the amendments are rationally related to that purpose, there is no due process or other constitutional violation.

I. Background

A. Factual Background

Beginning in 1988, the Kentucky Revenue Cabinet began interpreting KRS 141.120 to disallow the filing of a combined tax return under the unitary business concept. In Revenue Policy (RP) 41P225, the Cabinet determined to literally apply the language in KRS 141.120 which stated that such returns were disallowed. Prior to this, for sixteen years, the Cabinet had allowed qualified businesses to choose whether to file separate returns or a combined return under the unitary business concept. RP 41P225 made it clear that only separate returns would be allowed despite the fact that a group of corporations might function under a unitary business plan.

Many corporate enterprises function as clusters or chains of related corporations, often across many state lines. Determining how to apportion corporate income to allow for taxation in each state can be extremely difficult and can lend itself to tax "dodges" or fraud. One method to arrive at proper taxation for a specific part of a business chain is to simply tax each part separately. Another method, known as a combined return under a unitary business plan, lets the corporate entity file as a whole, then apportions the state tax according to some formula. There are pros and cons to both methods which are not germane here.

The Appellees originally filed separate tax returns. In 1994, this Court decided *GTE v. Revenue*

Cabinet, Commonwealth of Kentucky, 889 S.W.2d 788 (Ky. 1994), which held that related corporations (such as a parent and subsidiary) could file a combined tax return under the unitary business concept. After *GTE* was decided, the Appellees in this case sought to amend their returns by substituting combined returns under the unitary business concept as allowed in *GTE,* because they would owe less tax under such an approach and could therefore claim a refund of taxes they claim to have overpaid.

Recognizing that applying *GTE* would result in a significant and unanticipated revenue loss, the General Assembly repeatedly amended the relevant statutes to bar the type of combined returns under the unitary business plan that the Appellees amended to file, and to bar the payment of any tax refunds that would be due to persons filing this type of amended return. The Appellees claim these statutory amendments have denied them due process of law and violated equal protection.

B. Procedural and Legislative History of KRS 141.120 and KRS 141.200

Two statutes actually lie at the heart of this controversy: KRS 141.120 and KRS 141.200. Because they have been subject to significant amendment and shifting interpretations, some recounting of that history will be helpful in understanding this case.

1. Before 1996

GTE read the version of KRS 141.120 in effect at that time to "authorize multiple corporations engaged in a unitary business to file combined income tax returns." *GTE,* 889 S.W.2d at 791. As noted above, this meant that related corporations (e.g., a parent and subsidiary) could effectively file a single tax return. The Court so held despite the fact that KRS 141.200(1) at the time required that "[c]orporations that are affiliated must each make a separate return." The Court read "corporation" as used in KRS 141.200 to mean both individual corporations and groups of corporations that operated as a "unitary business." *GTE,* 889 S.W.2d at 793.[1] This meant that

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[1] Specifically, the Court stated:

> Although we recognize the argument by the Revenue Cabinet that KRS 141.200(1) requires separate corporate filings, we do not agree with the interpretation placed on the last sentence of that statute. "Corporations" is defined by KRS 141.010(24) as having a meaning consistent with the definition of the word in § 7701(a)3 of the Federal Internal Revenue Code. 26 U.S.C. 7701. The concept of apportionment among states obviously has no place within the confines of the Federal tax plan. Our interpretation of the word "Corporation" as used in KRS 141.200(1) is, however, consistent with the Federal definition. We interpret the last phrase of § 1, which is "corporations that are affiliated" to refer to unitary corporations such as GTE and Subsidiaries. The statute merely requires that each unitary corporation file a separate corporate income tax return. It does not mean that each component corporation of the unitary group must file

(Continued on following page)

GTE and its subsidiaries would be treated as a single business under the "unitary business concept" and they could therefore file a combined return.

2. The 1996 Amendments

The General Assembly amended KRS 141.120 substantially in 1996, directly in response to the Court's decision in *GTE,* with the change having retrospective effect to any tax year ending on or after December 31, 1995. *See* 1996 Ky. Acts ch. 239, §§ 1, 3. A section was added that read, "Nothing in this section shall be construed as allowing or requiring the filing of a combined return under the unitary business concept or a consolidated return." KRS 141.120(11).

KRS 141.200 was amended in its entirety, with its changes having retrospective effect to any tax year ending on or after December 31, 1995. *See* 1996 Ky. Acts ch. 239, §§ 2, 3. The "[c]orporations that are affiliated must each make a separate return" language was removed. In its place, the General Assembly included definitions of "affiliated group" and "consolidated returns," both of which referenced the federal Internal Revenue Code. The General

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> separately. The taxation statutes differentiate between simple corporations and unitary corporations. This statute simply requires a return for both classes of corporate taxpayers.

GTE, 889 S.W.2d at 792-93.

Assembly also included language allowing "affiliated groups" to file "consolidated returns."

The effect of this legislation was to undo the "unitary business concept" injected into the law by *GTE* while allowing parent-subsidiary groups of corporations, like those involved in the *GTE* litigation, to file what amounted to a single return going forward from 1995. In other words, the General Assembly technically undid *GTE,* at least going forward, but implemented a substantially similar scheme under the "affiliated group" approach. This allowed the General Assembly to follow the national trend that *GTE* had recognized while giving it more control over the process than the judiciary.

3. The 1998 Budget Bill

Sometime in 1996 to 1998, the Revenue Cabinet realized that *GTE*'s interpretation of KRS 141.120 was creating substantial tax refund liabilities for the state for the years prior to 1995. The General Assembly was not apprised of, or at least was not able to address, these problems until late in the 1998 Regular Session, when it was well into the budgeting process. Because legislative sessions were only held every other year then, the first chance to deal with the problem with direct legislation would come two years later. To at least temporarily patch the problem, the General Assembly inserted a provision in the 1998 Budget Bill barring the state treasury from paying out any refunds sought pursuant to the theory

announced in *GTE*. The Budget Bill would only be in effect for two years, meaning the problem would have to be addressed fully in 2000.

4. The 2000 Amendments

In 2000, the General Assembly finally had a chance to deal directly with the emerging problem created by those corporations trying to file amended returns for years before 1995 to take advantage of *GTE*'s interpretation of the version of KRS 141.120 in effect in those years.

It amended KRS 141.120 to remove the express bar on filings under the "unitary business concept" found in the 1996 version at KRS 141.120(11). *See* 2000 Ky. Act. ch. 543, § 2. This was not a rollback of the disapproval of the "unitary business concept," however.

Instead, the General Assembly again amended KRS 141.200 substantially to address the problem. *See* 2000 Ky. Act. ch. 543, § 1. The amendment added the following language:

> (7) For any taxable year ending on or after December 31, 1995, except as provided under subsection (3) of this section, nothing in this chapter shall be construed as allowing or requiring the filing of:
>
> (a) A combined return under the unitary business concept; or
>
> (b) A consolidated return.

(8) No assessment of additional tax due for any taxable year ending on or before December 31, 1995, made after December 22, 1994, and based on requiring a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return, shall be effective or recognized for any purpose.

(9) No claim for refund or credit of a tax overpayment for any taxable year ending on or before December, 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return, shall be effective or recognized for any purpose.

(10) No corporation or group of corporations shall be allowed to file a combined return under the unitary business concept or a consolidated return for any taxable year ending before December 31, 1995, unless on or before December 22, 1994, the corporation or group of corporations filed an initial or amended return under the unitary business concept or consolidated return for a taxable year ending before December 22, 1994.

(11) This section shall not be construed to limit or otherwise impair the cabinet's authority under KRS 141.205.

KRS 141.200. The bill also had language stating that subsection (7) "shall apply retroactively for taxable years ending on or after December 31, 1995," and that subsections (8) to (11) "shall apply retroactively for all taxable years ending before December 31, 1995." 2000 Ky. Acts ch. 543, § 3.

The effect of this amendment was to maintain the bar on combined returns under the "unitary business concept" and to retrospectively apply that bar to years before 1995. Because there was no alternative for filing "consolidated returns" for "affiliated groups" in those years, as had been allowed beginning in 1995 under the 1996 amendments, this new amendment purported to undo any effect *GTE* might have had prior to 1995.

5. Subsequent Amendments

Subsequent amendments of KRS 141.120 and .200 left the 1996 and 2000 amendments substantially intact. Also, KRS 141.200 has been amended to include provisions related to "affiliated groups" and "consolidated returns" for the tax years 2004 to 2007. This has had the effect of moving KRS 141.200(7)-(11), as found in the 2000 version of the statute, to KRS 141.200(15)-(19). For present purposes, however, the law appears to be substantially the same as it appeared in 2000.

II. Analysis

A. Sovereign Immunity

Appellants argued that Appellees cannot obtain a tax refund in this action from Revenue because the legislature withdrew its consent, specifically, to be sued for a refund under a combined return based on the unitary business plan in KRS 141.200(17). Certainly, that is the plain meaning of that section. However,

> The constitutional privilege of a State to assert its sovereign immunity in its own courts does not confer upon the state a concomitant right to disregard the Constitution or valid federal law. The States and their officers are bound by obligations imposed by the Constitution and by federal statutes that comport with the constitutional design. . . .
>
> Sovereign immunity does not bar all judicial review of state compliance with the Constitution and valid federal law.

Alden v. Maine, 527 U.S. 706, 755-56 (1999).

The Appellees have raised a federal due process challenge to the 2000 amendments. As such, their federal constitutional claims must be considered under the Supremacy Clause. If there is a federal constitutional violation, that law prevails.

B. Due Process

The term "due process" has two meanings in American jurisprudence: (1) substantive due process, which is based on the idea that some rights are so fundamental that the government must have an exceedingly important reason to regulate them, if at all, such as the right to free speech or to vote; and (2) procedural due process, which requires the government to follow known and established procedures, and not to act arbitrarily or unfairly in regulating life, liberty or property. Since the Appellees have paid taxes and are seeking a refund by amending their separate returns to a combined return under the unitary business concept for the years in question, they claim a property interest will be taken without due process of law if the amended tax statutes are allowed retroactive application to bar their claims.

It has been established that "a taxpayer has no vested right in the Internal Revenue Code." *United States v. Carlton,* 512 U.S. 26, 33 (1994). (Nor, by comparison, is there a vested right in the Kentucky Revenue Code.) By this statement, written by Justice Blackmun, the United States Supreme Court held that there is no substantive due process right which prevents retroactive tax law applications. The Supreme Court explained:

> "Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to

> enjoy its benefits and must bear its burdens. Since no citizen enjoys immunity from that burden, its retroactive imposition does not necessarily infringe on due process. . . ."

Id. (quoting *Welch v. Henry*, 305 U.S. 134, 146-47 (1938)) (omission in original).

Having determined that matters involving taxation do not involve a fundamental right (and thus did not implicate substantive due process), the Supreme Court also undertook to determine whether retroactive application of a tax statute, without notice and causing loss to the taxpayer, would violate procedural due process. After a painstaking analysis, the Supreme Court determined that as long as the statutory amendment was rationally related to a legitimate legislative purpose, it would not violate due process.

The Supreme Court began its analysis by recognizing a number of cases wherein it upheld retroactive tax legislation against a due process challenge when the legislation was not so "'harsh and oppressive as to transgress the constitutional limitation.'" *Id.* at 30 (quoting *Welch v. Henry*, 305 U.S. 134, 147 (1938)). To explain "harsh and oppressive," the Court stated that these words were equivalent to "arbitrary and irrational," *id.*, and explained:

> "'Provided that the retrospective application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such

> legislation remain within the exclusive province of the legislative and executive branches. . . .
>
> . . . The retrospective aspects of legislation, as well as the prospective aspects, must meet the test of due process, and the justifications for the latter may not suffice for the former. . . . *But that burden is met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose.*'"

Id. at 30-31 (quoting *Pension Benefit Guaranty Corporation v. R.A. Gray & Co.*, 467 U.S. 717, 729-30 (1984)) (some internal quotation marks omitted, citations omitted, emphasis added, first and third omission in original).

The Respondent in *Carlton* had legitimately taken advantage of an estate tax deduction under a revised statute which would have saved the estate a significant amount of money. A little over a year later, Congress recognized that the statute was overbroad and enacted a curative amendment limiting the deduction to such a degree that it would no longer apply to the estate. It did so by making the amendment retroactive as if incorporated in the original deduction provision. The IRS disallowed the deduction, and Carlton paid the asserted deficiency, plus interest. He then filed a claim for a refund, and instituted a refund action in federal district court, claiming a due process violation. The district court rejected his due process argument. A divided panel of

the Ninth Circuit Court of Appeals reversed on the grounds of inadequate notice of the retroactive amendment and that the taxpayer had relied to his detriment on pre-amendment law.

The Supreme Court found that Carlton's lack of notice was not dispositive because a taxpayer takes his chances that there will be an increase in the tax burden which might come about when the government carries out an established policy of taxation. Further, it held that since the amendment had not been made for an improper purpose, such as inducing Carlton to rely on the statute only to target him after the fact, and given that he had no immunity from taxation because it was neither a penalty nor a liability but only his obligation in exchange for the benefits of government, his reliance on the pre-amendment statute alone was insufficient to establish a constitutional violation.

Instead, the Supreme Court held the view of the Ninth Circuit Court of Appeals to be an unduly strict standard: "Because we conclude that retroactive application of the 1987 amendment to Section 2057 is rationally related to a legitimate legislative purpose, we conclude that the amendment as applied to Carlton's 1986 transactions is consistent with the Due Process Clause." *Id.* at 35. It is notable that this ultimate holding did not mention a "modesty" requirement (on which the Court of Appeals relied in this case), though the majority did note with favor that Congress had acted promptly and applied only a modest period of retroactivity (meaning that the

length of the period of retroactivity is to be considered as part of the test of whether the statute is a rational means of achieving the government's goal).

In fact, only Justice O'Connor stated in her concurring opinion that the retroactivity period should not exceed one year, thus implying that she considered "modesty" to be a due process guarantee. Her separate opinion carried no other votes.

Justices Scalia and Thomas, in a separate concurring opinion, took the view that time is not even a relevant consideration. Instead, they focused on the fact that the taxpayer has already relied on the statute, and the amendment comes after that reliance. They felt that whether the amendment comes immediately after or long after does not change the fact of deprivation after reliance on then existing law. *See id.* at 40 (Scalia, J., concurring) ("The reasoning the Court applies to uphold the statute in this case guarantees that *all* retroactive tax laws will henceforth be valid.").

Retroactive application of a statute need only be (1) supported by a legitimate legislative purpose (2) furthered by rational means, which includes an appropriate modesty requirement. This requires analysis of the facts and circumstances of each case, rather than applying a specified modesty period. The pertinent question is whether the period of retroactivity is one that makes sense in supporting the legitimate governmental purpose (rationally related).

Despite these differences, Justices O'Connor, Scalia and Thomas did concur in the result of the case, joining the majority in saying that retroactive application of revenue measures is rationally related to the legitimate governmental purpose of raising revenue, to prevent a "significant and unanticipated revenue loss." As Justice Scalia wrote in his separate concurring opinion,

> To pass constitutional muster the retroactive aspects of the statute need only be "rationally related to a legitimate legislative purpose." Revenue raising is certainly a legitimate legislative purpose, and any law that retroactively adds a tax, removes a deduction, or increases a rate rationally furthers that goal. I welcome this recognition that the Due Process Clause does not prevent retroactive taxes, since I believe that the Due Process Clause guarantees *no* substantive rights, but only (as it says) process.

Id. at 40 (Scalia, J., concurring) (internal citations omitted).

Clearly, eight of the nine justices viewed what may "rationally further" a legitimate governmental interest as being broader than the one year that only Justice O'Connor would impose as a "modesty" measure. Thus what is "modest" or acceptable for due process purposes depends on the facts of the case, including notice, settled expectations, detrimental reliance, etc.

This was demonstrated when, following *Carlton*, in 1996 the Ninth Circuit (where *Carlton* originated) held in *Montana Rail Link, Inc. v. United States*, 76 F.3d 991 (9th Cir. 1996), that a statute with a seven year retroactivity period did not violate due process. The facts of that case are strikingly similar to this one.

Montana Rail was required to pay an excise tax on compensation it paid to its employees, and to withhold a tax imposed on railroad employees under a retirement system separate from social security though paid to the Internal Revenue Service. For several years, Montana Rail treated as taxable compensation its contributions to 401(k) plans, but on advice of the Railroad Retirement Board, stopped including 401(k) contributions when calculating the amount of employee compensation for retirement fund purposes in 1987 and 1988. This resulted in what it considered to be a tax overpayment for those years, so Montana Rail refunded that amount to its employees, and sought a refund of this overpayment from the government.

In December 1989, Congress redefined the railroad retirement tax compensation base to specifically include contributions to 401(k) plans as part of the taxable compensation, and specifically made the change retroactive to "'remuneration paid before January 1, 1990. . . .'" *Id.* at 993 n.1 (quoting Omnibus Budget Reconciliation Act of 1989, § 10206(c)(2)(A)). This affected the tax status of these retirement contributions from 1983, when the

ambiguity arose, forward. Montana Rail's refund request was denied. But it claimed that it had relied on the advice of the Board and the then existing state of the law, and that to deny its refund would violate due process. Montana Rail filed suit in federal district court seeking the refund, but its claim was denied there also.

The Ninth Circuit Court of Appeals upheld the district court ruling, specifically applying *Carlton* to find that Congress had the legitimate legislative purpose of protecting the reliance interests of employees who were expecting to receive higher benefits based on the taxes paid and withheld, and to avoid loss of revenue. It specifically held that the period of retroactivity bore a rational relation to the underlying legislative purpose, and that the seven year retroactivity period was appropriate because

> [g]iving § 10206(b) a one or two year period of retroactivity would have severely hurt workers who had retired expecting that they would receive a level of benefits based in part on tax payments made from 1983 through 1987. A shorter period of retroactivity would have been arbitrary and irrational.

Id. at 994 (internal citations omitted).

Further the Ninth Circuit pointed out that

> MRL erroneously equates its mistaken overpayment of taxes with the government's "unlawful," "improper" and "erroneous" collection

> of taxes. Contrary to MRL's assertion, the IRS did not violate any federal law by accepting MRL's overpayment. Seeking a refund for one's own voluntary overpayment of a lawful tax is not the same as pursuing a remedy for payment of an illegal tax.

Id. at 995.

In light of *Carlton* and *Montana Rail* it becomes clear that the opinion of the Kentucky Court of Appeals gave undue weight to dicta in Justice O'Connor's concurring opinion when it held that this case turned on a one year "modesty" requirement. The issue instead is only whether the retroactive statute of 2000 rationally furthers the legitimate governmental purpose of raising and controlling revenue to prevent a significant and unanticipated revenue loss. Applying that test here, there can be no question that the legislature acted to correct what it viewed as a mistake in *GTE*'s interpretation of the law, that it had a legitimate governmental purpose (raising and controlling revenue) and that the statute rationally furthers this purpose. Further, to prevent a significant and unanticipated revenue loss, Appellees had been on notice of the revenue intent from 1988 when RP 41P225 was issued until 1994 when *GTE* was decided, and could not have had any "settled expectations" to the contrary.

Additionally, the legislature's intent to supercede *GTE* became apparent almost immediately. In the 1996 session, the legislature amended KRS 141.120 to disallow filing a combined return under the

unitary business concept, and developed its own approach to filing a consolidated return based on affiliation, specifically ownership. It made the statute effective for any tax year ending on or after December 31, 1995. That taxpayers would attempt to amend their returns to combined returns under the unitary business concept in order to claim under the refund statute was literally an unknown, because the legislature had no means of knowing who would wish to combine their separate returns in order to request a refund, or even if a refund would be required after they did.

By the beginning of the next biennial legislative session the effect of *GTE* was still not clear. Sometime during the session, however, evidence of such claims was raised, and the problem was addressed through the budget bill, which directed Revenue not to pay refunds on attempts to amend separate returns to combined returns under the unitary business concept in order to make a claim for a refund under *GTE*. By the 2000 session, the problem had been defined, and the legislature amended KRS 141.200 to disallow the filing of combined returns under the unitary business concept for any taxable year ending on or before December 31, 1995, and to disallow the payment of refunds on amended returns filed after December 22, 1994, (not coincidentally, the date *GTE* was decided). At the first reasonable opportunity, as it became aware of the issues, the legislature, which met then only biennially, made provisions and amendments.

While it might be tempting to require the legislature to be omniscient so as to immediately understand the ramifications of case law on statutory application, history tells us that often the development of law based on the holdings in cases takes time to go through process before the clear impact can be seen. Combine this with delays caused by a biennial legislative schedule, and it is rational that the legislature acted with reasonable diligence in this complicated matter.

As *Carlton* held, to pass constitutional muster, a retroactive statute need only be rationally related to a legitimate legislative purpose, which in this case as in *Carlton* was a significant and unanticipated revenue loss. Revenue raising is the sole province of the legislature, and the courts should involve themselves in it only when clear constitutional or interpretive issues arise. While due process is certainly a constitutionally protected right, it is not impacted under the facts of this case, given the clear and lengthy notice, the lack of settled expectations and lack of detrimental reliance. All the legislature did was clarify the statute after this Court interpreted it in *GTE*.

Taking another tack, Appellees have argued that in a case decided before the Supreme Court later in 1994, the Court ruled that a State may not "bait and switch" remedies when a taxpayer seeks a refund of illegally or unconstitutionally collected taxes which require this Court to find that they are entitled to a refund of an overpayment of taxes due to being

required to file separate returns when they were entitled to file a combined return under the unitary business plan. *Reich v. Collins,* 513 U.S. 106 (1994). This case, however, is clearly distinguishable from the present circumstances on its facts and legal questions.

Reich concerned a common practice where state retirement benefits were exempt from state income taxes, but federal retirement benefits were not. After the Supreme Court found that this practice violated the constitutional intergovernmental tax immunity doctrine, most states repealed the special tax exemption for state retirees, but did not automatically refund the illegal taxes to federal retirees. Reich sued Georgia for a tax refund under its refund statute. The case took several twists and turns, but finally ended up with the United States Supreme Court holding that Georgia could not change its deprivation remedy in the middle of the stream by arbitrarily declaring that its clear post-deprivation remedy would no longer apply because it was going to exclusively rely on its pre-deprivation remedy. Justice O'Connor wrote that Reich was entitled to pursue the post-deprivation remedy, regardless of whether Georgia also had pre-deprivation remedies, because the language in the refund statute would lead the average taxpayer to think it obvious that he could avail himself of that remedy. Georgia had effectively taken away any remedy at all by changing to its pre-deprivation remedies exclusively after Reich had already paid the unconstitutional taxes.

The *Reich* decision followed *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco, Fla. Dept. of Business Regulation,* 496 U.S. 18 (1990), which dealt with an attempt by Florida to tax certain types of Florida products more favorably than other products that had been found to be unconstitutional as a violation of the Commerce Clause. The Florida Supreme Court had recognized the unconstitutionality, but had declared that relief would be prospective only, and did not allow a refund to the challengers. Reversing this, Justice Brennan wrote for a unanimous court

> If a State places a taxpayer under duress promptly to pay a tax when due and relegates him to a postpayment refund action in which he can challenge the tax's legality, the Due Process Clause of the Fourteenth Amendment obligates the State to provide meaningful backward-looking relief to rectify any *unconstitutional* deprivation.

Id. at 31 (footnote omitted, emphasis added).

It is important to note that the Supreme Court made its ruling in *McKesson* premised upon a refund being due for an *unconstitutional* application of a tax, which naturally impacts federal due process. However, this Court in *GTE* did not make a constitutional declaration, but instead merely interpreted a *constitutional* statute. That decision did not in any way impact the process for a remedy available to the taxpayers; it merely said that another process for filing returns was also available. Since constitutionality

was not involved, the analysis then goes from deprivation of property without due process of law to the well-established analysis of when and how the government may enact economic legislation, specifically revenue-controlling legislation, under the *Carlton* line of cases.

The present case differs from *Reich* and *McKesson* in many important ways. Here, Appellees claim that their right to file a combined return under the unitary business concept pursuant to the holding in *GTE* was improperly taken from them. They filed for a refund under *GTE*'s interpretation of the statute, but in order to be eligible to get a refund, they had to change their return from separate returns to a combined return under the unitary business concept, which required taking the paperwork of several different returns and combining them into one return. Only after this was done would Appellees become eligible for a refund. While they may have been denied their choice of the most advantageous return, the returns that they did file were not illegal, and certainly could have been the chosen method, even under *GTE,* if they would have been to the Appellees' advantage. In *Montana Rail*, the Ninth Circuit made this same point, distinguishing that case from *Reich*, in upholding a law that was very similar in effect to this one.

The most significant difference, however, is that *Reich* and *McKesson* did not involve the retroactive application of a state tax statute that effectively changed the amount of tax owed and which was

enacted for a legitimate governmental purpose. While *Reich* came out the same year as *Carlton*, the cases are on two entirely different issues. Where the state of Georgia arbitrarily took away a "clear and certain" post-deprivation *remedy* for taking undisputedly illegal taxes in *Reich*, the legislature in this case took away the *dispute*, and hence any illegality that might be claimed, by properly enacting a retroactive statute that mooted the question of whether the Appellees were entitled to a refund. By retroactively declaring that combined returns were disallowed prior to 1995 and that no refunds would be allowed due to amendments to file combined returns under a unitary business concept, the legislature reestablished the status quo as it saw it prior to *GTE*. The remedy provided by the refund statute was not affected at all; it simply no longer applies to the Appellees in this case because the underlying tax law has been changed, just as the deduction no longer applied in *Carlton*.

C. Equal Protection and Other Rights

The Appellees also argue that the tax amendments violate their equal protection rights and other rights under the Kentucky Constitution because other corporations were allowed to amend their returns and were granted tax refunds. However, the controlling fact in this case is the government's power to tax and to enact legislation that controls the revenue stream. Since a taxpayer has no immunity from taxation, which is not a contractual liability but

rather the shared costs of the benefits of government, no fundamental right is involved. *Carlton,* 512 U.S. at 33-34. Rather, statutes or practices that have the effect of distinguishing between entities solely on an economic basis are "presumed to be valid and . . . generally comply with federal equal protection requirements if the classifications that they create are rationally related to a legitimate state interest." *Durham v. Peabody Coal Co.,* 272 S.W.3d 192, 195 (Ky. 2008) (citing *City of Cleburne, Texas v. Cleburne Living Center,* 473 U.S. 432, 440 (1985)). The analysis is the same under the Kentucky Constitution. *Id.* This "rational basis" test is the same as required under due process for economic legislation, and, as discussed above, the 2000 amendments to the tax statute clearly satisfy it. The question in all matters falling short of a fundamental right, and particularly to economic or taxation legislation, is whether there is a legitimate governmental purpose for the action, and whether the means used to accomplish it rationally relates to that purpose. Having found that such a purpose exists in this case, there is no merit to the Appellees' claims.

III. Conclusion

Because the amendments to the Kentucky tax code made by the legislature in 1996 and 2000 were made to clarify the law in regard to combined returns under the unitary business plan and to exercise its revenue-raising powers, they further a legitimate governmental purpose. Moreover, the amendments

were rationally related to that purpose. Consequently, Appellees' due process rights have not been impacted and they are not entitled to tax refunds because they could not amend their separate returns to a combined return under the unitary business plan. The opinion of the Court of Appeals is reversed.

Scott and Venters, JJ., concur. Schroder, J., concurs in result only by separate opinion. Abramson, J., dissents by separate opinion in which Cunningham, J., joins. Minton, C.J., not sitting.

SCHRODER, JUSTICE, CONCURRING IN RESULT: While the majority utilizes the correct legal framework and arrives at the correct result, I disagree with some observations and portions of the analysis in its opinion. Therefore, I write a separate, albeit legally similar, opinion.

From 1972 through 1988, the Revenue Cabinet (the "Cabinet") interpreted KRS 141.120 to allow corporations to file unitary tax returns. In 1988, the Cabinet issued Revenue Policy 41P225, which prohibited the filing of unitary returns, and required separate returns.[1] GTE challenged the Cabinet's policy shift in a case that reached this Court in 1994.

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[1] The policy permitted unitary reporting only if the subsidiaries were a sham or paper corporation with limited viable activities. *GTE v. Revenue Cabinet*, 889 S.W.2d 788, 790 (Ky. 1994).

In an opinion rendered December 22, 1994, this Court decided in GTE's favor. *GTE v. Revenue Cabinet,* 889 S.W.2d 788 (Ky. 1994). *GTE* interpreted KRS 141.120 as allowing unitary filing, and invalidated RP 41P225 under the doctrine of contemporaneous construction. *Id.* at 792. Because their taxes would have been lower under the unitary method of filing, a number of corporations, seeking refunds, thereafter amended their returns to unitary returns for various years in which RP 41P225 was in effect. Although the Cabinet acted on some of the refund claims, it took no immediate action on Appellees' claims.

The Cabinet began tracking actual and potential claimants and the amount of their claims by the end of 1995. At that time, the Cabinet estimated the claims to be worth about $50 million. In the first legislative session following the *GTE* decision, 1996, the General Assembly enacted H.B. 599, which abolished the filing of unitary returns for tax years ending on or after December 31, 1995. This legislation, however, had no effect on the pending refund claims.

In October 1996, the Cabinet estimated unpaid refund claims to be worth approximately $160 million, which rose to $177 million by April 1997. In response, to avoid a huge loss to the general fund, at the next legislative session, 1998, the General Assembly included in the 1998-2000 budget bill, a measure which prohibited the Revenue Cabinet from paying any post-*GTE* refund claims. H.B. 321, § 33. Several parties challenged the prohibition. The

Franklin Circuit Court invalidated the provision on grounds that it did not comply with the "reenactment and republication" provisions of Section 51 of the Kentucky Constitution. The Cabinet appealed to the Court of Appeals. While the appeal was pending, H.B. 321 expired on its own terms (in 2000), and the Court of Appeals dismissed the appeal as moot.

The claims had risen to nearly $200 million at the end of June 1998, with $65 million of that being interest. At the 2000 legislative session, faced with this massive drain of the state treasury as a result of the pending refund claims, the General Assembly enacted H.B. 541, the legislation at issue in this case. H.B. 541 substantially amended KRS 141.200, and (1) prohibited refund claims for taxable years ending on or before December 31, 1995, made by amended return filed after December 22, 1994, based on a change from separate to unitary return, and (2) prohibited corporations from filing unitary returns for tax years ending before December 31, 1995, unless the corporations filed unitary returns on or before December 22, 1994, for tax years ending before December 22, 1994. The effect of H.B. 541 was to extinguish Appellees' refund claims.

Two declaratory judgment actions were filed in the Franklin Circuit Court seeking to have the retroactive portions of H.B. 541 declared unconstitutional. The two cases were consolidated and the circuit court, finding the legislation constitutional, granted summary judgment to the Cabinet. The Court of Appeals reversed on grounds that the period

of retroactivity was excessive. This Court granted discretionary review.

It is well settled that a tax act is not necessarily unconstitutional because it is retroactive. *Welch v. Henry,* 305 U.S. 134, 147 (1938). Retroactive tax legislation satisfies the Due Process Clause provided that it "'is supported by a legitimate legislative purpose furthered by rational means.'" *United States v. Carlton,* 512 U.S. 26, 30-31 (1994) (*quoting Pension Benefit Guaranty Corporation v. R.A. Gray & Co.,* 467 U.S. 717, 729 (1984)). The United States Supreme Court has repeatedly upheld retroactive tax legislation against a due process challenge. *Id.* at 30 (*citing United States v. Hemme,* 476 U.S. 558 (1986); *United States v. Darusmont,* 449 U.S. 292 (1981); *Welch v. Henry,* 305 U.S. 134 (1938); *United States v. Hudson,* 299 U.S. 498 (1937); *Milliken v. United States,* 283 U.S. 15 (1931); *Cooper v. United States,* 280 U.S. 409 (1930)).

The General Assembly's purpose in enacting H.B. 541 was to prevent a massive loss to the state treasury as a result of the *GTE* decision.[2] In *United*

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[2] The legislative purpose of H.B. 541 could not be more clear:

> "[I]f we don't do this [pass H.B. 541], it could cost us up to $190 million . . . These corporations that are involved did not plan their business based on filing the way that they are now attempting to come back and get refunds . . . But now they want to come back and raid the state treasury . . . to the tune of $190 million. And that's what this bill is all about . . . [I]f

(Continued on following page)

States v. Carlton, the United States Supreme Court held that the prevention of a "significant and unanticipated revenue loss" satisfies due process as a legitimate legislative purpose for a retroactive tax statute. 512 U.S. at 32. *Carlton* involved a new estate tax provision, 26 U.S.C. Section 2057, enacted on October 22, 1986, which granted a deduction for half the proceeds of "any sale of employer securities by the executor of an estate" to "an employee stock ownership plan." *Id.* at 28. The purpose of the deduction was to promote employee ownership. Congress initially estimated a revenue loss from Section 2057 of approximately $300 million over a five year period. *Id.* at 31-32. On December 10, 1986, Carlton, executor of an estate, used estate funds to purchase MCI stock for $11.2 million which he resold two days later to the MCI ESOP for $10.6 million, a loss of $600,000, for the express purpose of claiming a tax deduction of $5.3 million (half the proceeds of the sale) under Section 2057, reducing the estate tax by $2.5 million.

Shortly after its passage, Congress realized that the expected revenue loss from Section 2057 could be as much as $7 billion, because of a loophole in the law which did not limit the deduction to situations in which the decedent owned the securities immediately before death. *Id.* at 32. To protect the treasury

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we don't do it, then we better figure out how to cut the budget $190 million." Remarks of Chairman Moberly, Transcript of Hearing on H.B. 541, February 22, 2000.

against this massive loss, on December 22, 1987, approximately one year after Carlton's stock transaction, Congress amended Section 2057 to require that the securities sold to an ESOP must have been owned by the decedent immediately before death. The 1987 amendment was made retroactive as if it had been contained in the statute as originally enacted in October, 1986. *Id.* at 29. Carlton's December, 1986, transaction was invalidated, causing the estate to incur a significant loss.

The Court upheld the 1987 amendment's retroactivity against Carlton's due process challenge. The Court held that the prevention of a "significant and unanticipated revenue loss" was a legitimate legislative purpose, and that the amendment was a rational means of achieving said purpose. *Id.* at 32, 35. The Court recognized that while Congress might have chosen to make up the loss by burdening equally "innocent" taxpayers, through general prospective taxation, it was not arbitrary nor unreasonable to choose to prevent the loss by retroactively denying the deduction to taxpayers who had engaged in purely tax-motivated (albeit legal) stock transfers. *Id.* at 32. The Court found Carlton's detrimental reliance upon the provision and lack of notice insufficient to establish a due process violation, as "[t]ax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code." *Id.* at 33. The Court observed with approval that the period of retroactivity was short, just over one year. *Id.* at 32-33. The period was therefore one that did not upset

long-standing [sic] and settled taxpayer expectations. *See id.* at 37-38 (O'Connor, J., concurring).

Similarly, H.B. 541 serves the legitimate legislative purpose of preventing a massive loss to the state treasury as a result of refund claims being filed in the wake of *GTE*. The legislature's decision to prevent the loss by prohibiting amended returns under the unitary method filed after December 22, 1994 (the date *GTE* was rendered) for years prior to 1995 is rationally related to that purpose. The Franklin Circuit Court and Court of Appeals correctly found as such.

The Court of Appeals erred, however, in concluding that H.B. 541 nevertheless violated due process because its period of retroactivity was excessive. The Court of Appeals misinterpreted *Carlton* as setting a bright-line rule as to what is an acceptable period of retroactivity, relying on the Court's approval of the "modest" (slightly over one year) period of retroactivity in that case. The consideration of "modesty" relates to a taxpayer's right at some point to settled expectations. *See Carlton*, 512 U.S. at 37-38 (O'Connor, J., concurring). In this regard, the United States Supreme Court has indicated that where a taxpayer had no notice or could not have anticipated a change in a tax (as in *Carlton*) that it is plausible a tax could attempt to reach so far into the past as to offend due process. *Welch*, 305 U.S. at 148. The Court has never established a bright-line rule as to what this period would be. Rather, whether a retroactive tax act

"transgress[es] the constitutional limitation" depends upon the facts and circumstances of the particular case. *Id.* at 147; *Milliken v. United States,* 283 U.S. 15, 21 (1931).

The Court has indicated, however, that where at the time of the taxable event the taxpayer *had* notice of even a potential change in a tax law, due process is not offended when the retroactive period encompasses the time of the taxable event. *See Milliken,* 283 U.S. at 21, 24; *see also Welch,* 305 U.S. at 147-148. At the time of the taxable event in this case (the receipt of income during the years RP 41P225 was in effect), the Appellees were fully aware that their tax liability would be computed under the separate return method. They paid their taxes under the separate return method. They were not permitted to file unitary, and could have had no "settled expectations" to the contrary. At this point, if there were any "settled expectations" they were the Commonwealth's, not the taxpayers'. *King v. Campbell County,* 217 S.W.3d 862, 870 (Ky.App. 2006). Nor did Appellees obtain a vested right in a refund following the *GTE* decision. *See id.* at 869-870. The Appellees' expectations could not be deemed settled or vested in this case. As the majority noted, the legislature's intent to supercede *GTE* became apparent almost immediately – at the first legislative session following *GTE,* the General Assembly began a process of legislatively

undoing the decision.[3] As the influx of claims increased, so did the General Assembly's response, culminating in its response here, H.B. 541. Therefore, I agree with the majority that the period of retroactivity does not impact due process under the facts of this case, given the clear and lengthy notice, the lack of settled expectations, and the lack of detrimental reliance.

Finally, while it is well-settled [sic] that due process requires "meaningful backward-looking relief" for taxes collected in violation of the law or constitution, the taxes paid by the Appellees under the separate return method were neither illegal, nor unconstitutional. *McKesson Corp. v. Div. of Alcoholic Beverages and Tobacco,* 496 U.S. 18, 31 (1990); *Reich v. Collins,* 513 U.S. 106, 114 (1994).

As to the remaining issues, I concur with the result reached by the majority as well.

ABRAMSON, JUSTICE, DISSENTING: This corporate tax case presents a rather straightforward question: how aggressively may the General Assembly legislate after-the-fact in an effort to retain tax monies which this Court has held were collected in contravention of state law? Whether the taxpayer is an individual citizen or a corporation, the answer

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[3] A legislative body must have reasonable opportunity to act. *Welch,* 305 U.S. at 149.

to that question lies in the Due Process Clause of the Fourteenth Amendment to the United States Constitution which prohibits the taking of property without due process of law. Generally, a sovereign must provide "meaningful relief" in the form of a refund of the invalidly collected taxes and, while there is some latitude to legislate tax law retroactively, that power must be exercised promptly for a legitimate purpose and for a modest period. The 2000 Kentucky General Assembly exceeded the bounds of due process when it passed H.B. 541 in an effort to undo entirely this Court's ruling over five years earlier in *GTE v. Revenue Cabinet*, 889 S.W.2d 788 (1994). Neither the complete ban of all outstanding tax refund claims associated with the *GTE* case nor the retroactive rewrite of state tax law to condone the retention of corporate taxes invalidly collected five to twelve years previously passes constitutional muster. By upholding these long after-the-fact revisions of our tax laws, the majority misconstrues the constitutional restraints. Accordingly, I respectfully dissent.

While a full understanding of this matter entails appreciation of various approaches to corporate tax which are addressed later, the basic facts can be simply stated. For sixteen years, from 1972 until 1988, any corporation which qualified as a so-called "unitary business" was allowed to file Kentucky tax returns on a unitary or combined-reporting basis. In 1988, without any action on the part of our legislature, the Revenue Cabinet issued Revenue Policy 41P225, abruptly halting the right of virtually

all corporate taxpayers to file the unitary returns which had been accepted for years. Faced with higher taxes as a result of the stroke of an administrator's pen, several taxpayers sued and ultimately prevailed before the Kentucky Supreme Court. In *GTE v. Revenue Cabinet, supra,* this Court concluded that the Cabinet's and taxpayers' long-standing reading of KRS 141.120 was a reasonable one and, under the doctrine of contemporaneous construction, that reading had become binding on the Cabinet unless and until the General Assembly expressed a contrary intent.

Taxpayers responded to *GTE* by filing amended returns on a unitary basis but, after processing and settling some of the refund claims, the Cabinet sought legislative intervention. A stop-gap measure delaying all refunds was passed in 1998 and then an attempted complete "clean up" of the situation obliterating all rights to refunds was passed by the 2000 General Assembly in the form of H.B. 541. That bill had two provisions dedicated to a single purpose. One provision withdrew from those corporate taxpayers who had filed amended unitary returns and were seeking refunds post-*GTE* the basic refund right codified in KRS 134.580 and ordinarily available to all taxpayers who have paid taxes later determined to be invalid. The second provision was an attempt to recast pre-*GTE* law and destroy the legal underpinnings of the taxpayers' refund claims (and this Court's holding in *GTE*) by stating

retroactively that indeed the position stated by the Cabinet in RP 41P225 had always been the law.

Our Court of Appeals invalidated H.B. 541 as a violation of the taxpayers' due process rights. On appeal, the Cabinet maintains that the appellate court's due process analysis was wrong and in any event the Commonwealth's sovereign immunity trumps the taxpayers' due process rights. The Commonwealth argues, in essence, that it can collect taxes in contravention of law, litigate and lose before this Court, and then assert sovereign immunity to retain tax monies this Court found were invalidly collected. The sovereign is powerful but it too must answer to the Constitution and, more specifically, it too is constrained by the due process protections afforded its citizens for otherwise that Clause would be rendered meaningless. H.B. 541 is unconstitutional and these taxpayers are entitled to pursue the meaningful remedy which is codified in KRS 134.580, grounded in the Due Process Clause and available to all taxpayers who have paid taxes subsequently deemed invalid.

RELEVANT BACKGROUND AND PROCEDURAL HISTORY

Tax litigation is almost inevitably complex and this case is no exception. A brief discussion of the "unitary business concept" and its history in Kentucky tax law will provide context for the analysis that follows.

State Tax of Corporate Income-Apportionment.

Many corporations today engage in businesses that extend into more than one state and thus states wishing to tax these corporations' income are confronted with the problem of apportioning that income among themselves.[1] Almost since the inception of income taxes, various methods of effecting that apportionment have been employed, but in 1966 our General Assembly adopted the method devised by the American Bar Association's Commission on Uniform State Laws and published as the Uniform Division of Income for Tax Purposes Act (UDITPA). *See* KRS 141.120. Under UDITPA, a multi-state enterprise's income is characterized as either business or non-business. The non-business income is allocated to the source state pursuant to various sourcing rules, while the business income—income arising from transactions and activity in the regular course of a trade or business—is apportioned among the states contributing to that income according to an apportionment formula based on the proportion of the enterprise's property, payroll, and sales in the taxing state compared with its total property, payroll, and sales. Although the General Assembly has since modified the apportionment formula to give additional

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[1] This is a problem fraught with constitutional implications, as the states' ability to tax interstate enterprises is significantly constrained by both the Due Process Clause and Commerce Clause. *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980).

weight to the sales factor, Kentucky's approach to apportionment is still essentially the formulary UDITPA approach adopted in 1966. KRS 141.120(8).

Determining the Apportionable Income.

Separate Accounting.

Related to the problem of apportioning a multi-state enterprise's business income is the no less fundamental problem of defining the enterprise whose income is to be apportioned. The problem arises from the fact that many corporate enterprises are organized not as single corporations but as clusters or chains of related corporations. This fact has given rise to three primary taxing responses. One response is for the taxing state to ignore the larger enterprise and to treat each corporate component as a separate entity, taxing the entities with nexus in the state solely on the basis of their own individual incomes. This approach is known as the "separate entity" or "separate accounting" approach.

Combined Reporting.

Another approach is for the taxing state to treat the entire enterprise as in essence the entity to be taxed and to apply its apportionment formula to the entire group's combined income. This is the approach known as the "unitary-business/formula-apportionment" method or the "combined reporting" method. As one commentator has stated:

> The purpose of combined reporting is to determine the income of a multistate taxpayer attributable to a given state. This is accomplished by applying the apportionment factors of the unitary business to the unitary group's business income. . . .
>
> A combined report does not necessarily involve a single tax return for the group. Instead, it is the name given to a series of calculations by which a unitary business apportions its income on a geographic basis. In California, for example, each entity with nexus files its own return providing schedules reflecting the unitary activity. However, the [Franchise Tax Board] has adopted procedures under which some or all of the taxpayer-members of a unitary group may elect to file a group return.

Giles Sutton, "Comparison of Group Reporting Methods and Sourcing of Income," 9 St. & Loc. Tax Law. 29 (2004). A "unitary business" for this purpose is generally understood to be a multi-state, multi-corporate enterprise whose "operations conducted in one state benefit and are benefited by the operations conducted in another state or states. If its various parts are interdependent and of mutual benefit so as to form one integral business rather than several business entities, it is unitary." *Pioneer Container Corporation v. Beshears,* 684 P.2d 396, 399 (Kan. 1984) (internal quotation marks omitted). Where the components of a multi-state enterprise are integrated by sufficient unity of ownership, operation, and use,

the unitary business concept has been applied. *Edison California Stores, Inc. v. McColgan,* 183 P.2d 16 (Cal. 1947); *Armco Inc. v. Revenue Cabinet,* 748 S.W.2d 372 (Ky. 1988). The United States Supreme Court has held that the unitary-business/formulary-apportionment approach to corporate income taxation passes constitutional muster provided that "at least some part of [the unitary business] is conducted in the state," that "there be some bond of ownership or control uniting the purported 'unitary business,'" and that "the out-of-State activities of the purported 'unitary business be related in some concrete way to the in-State activities.'" *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159, 166 (1983). Indeed, at least in part because of its elevation of the enterprise's substance over its form, the U.S. Supreme Court has characterized the unitary business principle as "the linchpin of apportionability in the field of state income taxation." *Mobil Oil Corporation, supra,* 445 U.S. at 440.[2]

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[2] Many commentators have described the advantages of combined reporting, including fairness to single-state corporations, accuracy, tax neutrality between different forms of corporate organization, and freedom from the accounting and tax-loophole problems associated with cross-border transfers among related corporations. *See for example* John A. Swain, "Same Questions, Different Answers: A Comparative Look at International and State and Local Taxation," 50 Ariz. L. Rev. 111 (2008); Mark J. Cowan and Clint Kakstys, "A Green Mountain Miracle and The Garden State Grab: Lessons From Vermont And New Jersey on State Corporate Tax Reform," 60 Tax Law. 351 (2007). Nevertheless, largely as a result of successful corporate

(Continued on following page)

Consolidated Returns.

Kentucky's posture vis-à-vis combined reporting or the "unitary business concept" underlies the present controversy, but before turning to the specific facts of this case, a third legislative response to the taxing of multi-corporate enterprises deserves mention. Under federal tax law, an "affiliated group" of "includible corporations" may elect to file a "consolidated" return, *i.e.*, a single return for the entire affiliated group. 26 U.S.C. §§ 1501-1504. Sutton, "Comparison of Group Reporting Methods," *supra*. "Affiliation" for this purpose is not defined in terms of the member corporations' unified business, but solely in terms of ownership and control, generally including all inter-corporate connections where there is 80% or more of both ownership and control.[3] *Id.* A consolidated return is not the same as a combined or unitary report:

> A *combined report* is an *accounting* method whereby each member of a group carrying on

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lobbying, as of 2005 only seventeen states had adopted mandatory combined reporting. *Id.*

[3] The "unified business" for combined reporting purposes will not necessarily be the same as the "affiliated group" for consolidated return purposes. The unified business may include related entities with 50% to 80% ownership, for example, while the affiliated group will not, and the affiliated group will include all affiliates with 80% or more ownership, whether or not part of a unified enterprise, whereas the unified business will exclude entities that are not part of the same unified enterprise regardless of ownership share.

> a unitary business computes its individual taxable income by taking a portion of the combined net income of the group. A *consolidated return* is a *taxing* method whereby two corporations are treated as one taxpayer.

Caterpillar Tractor Co. v. Dept. of Rev., 618 P.2d 1261, 1262-63 (Ore. 1980).

Several states have adopted "consolidated return" provisions based on the federal model, and in 1996, the General Assembly amended KRS 141.200 by adding definitions of "affiliated group" and "consolidated return" that incorporate the corresponding federal definitions and by permitting affiliated groups to file consolidated returns, but only if the group consents to use consolidated status for eight years. Otherwise the 1996 version of KRS 141.200 requires separate entity reporting. The 1996 session of the General Assembly also amended KRS 141.120 by adding a provision expressly disavowing the "unitary business concept." The 1996 amendments have since been updated, and the provision disavowing the unitary business concept has been moved to KRS 141.200(15), but its basic reporting options remain in effect. Since 1996 it has been clear that the UDITPA-based apportionment provisions of KRS 141.120 apply to single corporations with income both within and without Kentucky and to "affiliated groups" of corporations with such multi-state income, but not to multi-corporate "unified businesses" under the "unitary business concept." Prior to 1996, however,

the law in Kentucky was less clear, and it is that prior law which underlies this case.

Procedural History

1972 - 1988—The Cabinet Accepts and Then Rejects Combined Reporting.

As noted above, formulary apportionment of interstate income was early on associated with the unitary business concept and combined reporting. Thus, although UDITPA does not itself include reporting provisions, the General Assembly's 1966 adoption of the UDITPA apportionment scheme was perceived by the Revenue Cabinet and by the courts as an embrace or a confirmation of combined or unitary reporting in Kentucky. That perception was based not only on case law upholding the use of combined reporting together with formulary apportionment, for example *Mobil Oil Corporation, supra, Butler Bros. v. McColgan,* 315 U.S. 501 (1942) and *Edison California Stores, Inc., supra,* but also on the fact that UDITPA is designedly consistent with a combined-reporting regime. In particular, as originally enacted in Kentucky, the UDITPA scheme required that "[a]ll business income shall be apportioned" pursuant to the property, payroll, and sales factors mentioned above. KRS 141.120(9) (1966). The law defined "business income" as "income arising from transactions and activity in the regular course of a trade or business of the taxpayer." KRS 141.120(1)(a) (1966). But "taxpayer" was left undefined, and thus

the state was free to include in its approach to "taxpayers" the unitary business concept and to require combined reports where appropriate if it so chose.[4] Encouraging such an approach in Kentucky, aside from the tenor of the times, was the fact that even apart from UDITPA, Kentucky law recognized the notion of multi-corporate income accounting. KRS 141.205(1) (1966), for example, provided that

> [t]he department may require any parent corporation or subsidiary corporation doing business within this state to file a consolidated return covering the entire operations of the parent corporation and its subsidiaries, whenever it finds that the inter-corporate transactions of the related group tend to reduce the net income of the corporation, or corporations, doing business within this state below the amount that would probably result if such corporation, or corporations, was not a member of the related group.

For these reasons, and perhaps others, in 1972 the Revenue Cabinet began allowing unitary businesses to file combined or unitary reports under KRS 141.120. In 1974, the General Assembly apparently endorsed this policy by amending KRS 141.205 to provide expressly for "combined" as well as

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[4] Another change introduced by the 1996 amendment of KRS 141.120 was substitution of the word "corporation" for UDITPA's "taxpayer."

"consolidated" returns: "The department may require either a consolidated return or a combined return from any or all corporations conducting intercorporate transactions whenever the department finds that such intercorporate transactions reduce taxable net income . . . below the amount which would result if the transactions were at arms-length." The Cabinet's combined-return policy continued, with the acquiescence of the General Assembly, until 1988. In September of that year, however, the Cabinet abruptly made an about face. Without any legislative changes in the tax laws, the Cabinet issued Revenue Policy 41P225, by which it purported to limit combined reporting to parent-subsidiary relationships in which the subsidiary was a mere "paper corporation with limited viable activities." The effect of this policy shift was essentially to halt the filing of combined reports in Kentucky.

GTE and Its Aftermath.

Protest was not long in coming. GTE, a New York corporation active in Kentucky that had filed combined reports uniting it with its subsidiaries, promptly challenged the legality of the new policy. In an opinion rendered on December 22, 1994, this Court invalidated RP 41P225 as inconsistent with the Cabinet's own long-standing interpretation of KRS 141.120. That interpretation was a reasonable statutory reading, the Court held, and so, under the doctrine of contemporaneous construction, that reading had become binding on the Cabinet until the

General Assembly expressed a contrary intent. *GTE*, 889 S.W.2d at 792-93.

In the wake of *GTE*, the Cabinet proposed a regulation mandating combined reporting in Kentucky. Kathryn L. Moore, "Taxation," 86 Ky. L. J. 875, 877-81 (1997-98). Corporate opposition was intense, however, prompting the withdrawal of the proposed regulation and adoption instead of the 1996 amendments to KRS 141.120 and 141.200 discussed above, the amendments disavowing the "unitary business concept" and providing for voluntary, federal-style consolidated returns. *Id.*

In the meantime, several corporate groups, including the Appellees, that had been precluded from filing combined reports during the life of RP 41P225 responded to *GTE* by filing amended returns on a combined or unitary basis for some or all of the affected tax years. Alleging that their tax liability was reduced when calculated on the basis of a combined report, these corporate groups also sought tax refunds. The Cabinet initially processed and settled a few of these refund claims, but by late 1996 or early 1997 its estimate of the claims' worth had risen substantially,[5] and at that point, apparently, the Cabinet ceased processing the claims and sought legislative intervention.

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[5] With interest, the outstanding claims are now said to total in excess of $200,000,000.00.

During its 1998 session the General Assembly enacted H.B. 321, which merely postponed the issue by providing that no post-*GTE* refund claims would be paid during the biennial budget period. That legislation expired in 2000. The 2000 session of the General Assembly then enacted H.B. 541, the legislation at issue here. As previously noted, H.B. 541 seeks to nullify Appellees' refund claims in two ways. First, it purports to withdraw retroactively in this small class of cases the refund remedy ordinarily available to taxpayers who pay taxes later determined to be invalid. Second, it purports to remove the legal basis of the Appellees' claims by retroactively validating RP 41P225.

The Court of Appeals held that the retroactive reach of H.B. 541 exceeds what the Due Process Clause allows. On appeal to this Court, the Cabinet challenges the Court of Appeals' reading of the due process issue and argues as well that in any event its sovereign immunity trumps Appellees' due process rights. But first, the Cabinet invites us to do some retroactive validating of RP 41P225 of our own by revisiting *GTE*. In their cross-motion for discretionary review, Appellees maintain that H.B. 541 is unconstitutional for reasons in addition to its due process infirmities, most notably equal protection concerns arising from the fact that some taxpayers' post-*GTE* refund claims were processed. These other concerns are significant and are given short shrift by the majority. Because I would affirm the Court of

Appeals on the due process issues, however, I will not address those other claims.

ANALYSIS

I. H.B. 541 Unconstitutionally Withdraws The Remedy For An Illegal Tax.

Section 1 of H.B. 541 amended KRS 141.200 in pertinent part by adding the following two provisions, now codified, respectively, as KRS 141.200(17) and 141.200(18):

> No claim for refund or credit of a tax overpayment for any taxable year ending on or before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return, shall be effective or recognized for any purpose.
>
> No corporation or group of corporations shall be allowed to file a combined return under the unitary business concept or a consolidated return for any taxable year ending before December 31, 1995, unless on or before December 22, 1994, the corporation or group of corporations filed an initial or amended return under the unitary business concept or consolidated return for a taxable year ending before December 22, 1994.

The first provision, KRS 141.200(17), pertains to the remedy available to corporate taxpayers post-*GTE*. As the parties note, in a case such as this one where the tax has not been challenged on constitutional grounds, KRS 134.580 is the applicable remedy statute. That statute provides in pertinent part that

> [w]hen money has been paid into the State Treasury in payment of any state taxes, except ad valorem taxes, whether payment was made voluntarily or involuntarily, the appropriate agency shall authorize refunds to the person who paid the tax, . . . of any overpayment of tax and any payment where no tax was due.

KRS 134.580(2). The Court of Appeals held, and I agree, that the Due Process Clause prohibits the General Assembly from withdrawing this remedy as KRS 141.200(17) purports to do.

A. The Due Process Clause Mandates A Meaningful Remedy When Taxes Are Collected in Contravention of Applicable Law.

The Due Process Clause of the Fourteenth Amendment to the United States Constitution provides that no state may "deprive any person of life, liberty, or property, without due process of law." The essence of this guarantee is that citizens must be given an opportunity, at a meaningful time and in a meaningful manner, to challenge the legality of the

government's impositions. *Mathews v. Eldridge,* 424 U.S. 319 (1976). Payment of a tax constitutes a deprivation of property, and the United States Supreme Court has held that to satisfy the requirements of the Due Process Clause, the taxing jurisdiction, the state in this case, must provide either predeprivation or postdeprivation procedural safeguards. *McKesson Corporation v. Division of Alcoholic Beverages and Tobacco,* 496 U.S. 18 (1990). Furthermore, where the state, as did Kentucky at the time these taxes were collected, requires or encourages its citizens to rely upon a postdeprivation refund action, that action "must provide taxpayers with, not only a fair opportunity to challenge the accuracy and legal validity of their tax obligation, but also a 'clear and certain remedy,' . . . for any erroneous or unlawful tax collection to ensure that the opportunity to contest the tax is a meaningful one." *Id.* at 39 (quoting from *Atchison, T. & S.F.R. Co. v. O'Connor,* 223 U.S. 280 (1912)). The state may not, moreover, "'hold[ing] out what plainly appears to be a 'clear and certain' postdeprivation remedy and then declare, only after the disputed taxes have been paid, that no such remedy exists.'" *Newsweek, Inc. v. Florida Department of Revenue,* 522 U.S. 442, 444 (1998) (quoting from *Reich v. Collins,* 513 U.S. 106, 108 (1994)). This, of course, is precisely what KRS 141.200(17) purports to do, and accordingly the Court of Appeals correctly determined that that statute violates the Due Process Clause.

B. The Due Process Guarantee Is Not Limited To Unconstitutional Taxes.

Against this conclusion, the Cabinet raises two arguments. It contends first that under *McKesson, supra,* the due process guarantee is only implicated by tax statutes ultimately found unconstitutional. While it is true that *McKesson* involved a tax invalidated under the Commerce Clause and thus the Court's discussion is sometimes couched in constitutional terms, the due process principle involved—that a taxpayer may not be deprived of his or her property without a meaningful opportunity to challenge the legality of the deprivation—clearly applies regardless of the ground for challenging the tax, whether federal constitution or, as here, state statute. Indeed *McKesson, supra,* cites earlier United States Supreme Court cases where due process mandated the refund of taxes collected, not in violation of the Constitution, but in violation of federal laws. *See, e.g., Ward v. Love County Bd. Of Comm'rs,* 253 U.S. 17 (1920) (taxes assessed in violation of federal treaty). More recently, the Supreme Court itself has noted that *McKesson* "and the long line of cases upon which *McKesson* depends, . . . stand for the proposition that 'a denial by a state court of a recovery of taxes exacted in violation of the laws or Constitution of the United States by compulsion is itself in contravention of the Fourteenth Amendment.'" *Reich,* 513 U.S. at 109. *McKesson,* thus, is not limited to deprivations which violate the U.S. Constitution, nor, indeed, should it be confined to those in violation of federal

law. A tax exacted in violation of state law, no less than one in violation of federal law, raises the exact same due process concerns and requires the same meaningful procedural safeguards.

C. Sovereign Immunity Does Not Trump The Due Process Guarantee.

The Cabinet also contends that KRS 134.580, the refund statute quoted above, effects a waiver of the state's sovereign immunity and that the General Assembly is free to withdraw that waiver and to reassert the state's immunity at any time and to any extent it deems appropriate. KRS 141.200(17) is merely, the Cabinet argues, a limited reassertion of immunity, which, the Cabinet insists, trumps Appellees' rights under the Due Process Clause.[6] In the case just cited, however, *Reich, supra,* the Supreme Court noted that the Due Process guarantee

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[6] KRS 141.200(17) makes no mention of immunity, of course, and thus the Cabinet's reading is by no means certain. In 2007, however, the General Assembly amended the refund statute itself by adding provisions "revoke[ing] and withdraw[ing] its consent to suit in any forum whatsoever on any claim for recovery, refund, or credit of any tax overpayment for any taxable year ending before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return." KRS 134.580(9)(a) and (b). Because the General Assembly's invocation of immunity is thus clear enough, it is appropriate to address the Cabinet's immunity argument without belaboring the construction of KRS 141.200(17).

applies notwithstanding "the sovereign immunity States traditionally enjoy in their own courts." *Id.* at 110. Five years later, in *Alden v. Maine,* 527 U.S. 706 (1999), the Supreme Court reviewed at length the constitutional and pre-constitutional bases of the states' immunity and held that Congress had no power to require waivers of that immunity. The Court distinguished *Reich,* however, and noted that the state's obligation in that case to provide the tax refund remedy it had held out to its citizens was not subject to sovereign immunity because it was an obligation arising from the Constitution.

> In *Reich v. Collins,* we held that, despite its immunity from suit in federal court, a State which holds out what plainly appears to be "a clear and certain" postdeprivation remedy for taxes collected in violation of federal law may not declare, after disputed taxes have been paid in reliance on this remedy, that the remedy does not in fact exist. This case arose in the context of tax-refund litigation, where a State may deprive a taxpayer of all other means of challenging the validity of its tax laws by holding out what appears to be a "clear and certain" postdeprivation remedy. In this context, *due process requires the State to provide the remedy it has promised. The obligation arises from the Constitution itself; Reich* does not speak to the power of Congress to subject States to suits in their own courts.

527 U.S. at 740 (citations omitted, emphasis supplied). Since *Alden,* several courts have noted that that case

> specifically preserved *Reich's* promise of a state-court remedy, noting, "The obligation arises from the Constitution itself, ..." Thus, where the Constitution requires a particular remedy, such as through the Due Process Clause for the tax monies at issue in *Reich,* or through the Takings Clause as indicated in *First English* [*Evangelical Lutheran Church v. County of Los Angeles,* 482 U.S. 304 (1987)], the state is required to provide that remedy in its own courts, notwithstanding sovereign immunity.

DLX, Inc. v. Kentucky, 381 F.3d 511, 528 (6th Cir. 2004) (quoting from *Reich*). *See, e.g. Seven Up Pete Venture v. Schweitzer,* 523 F.3d 948 (9th Cir. 2008); *Manning v. Mining and Minerals Division of the Energy, Minerals, and Natural Resources Department,* 144 P.3d 87 (N.M. 2006). I agree that this is the import of *Reich* and *Alden,* and conclude, therefore, that KRS 141.200(17) cannot be upheld even if construed as an assertion of the state's sovereign immunity. The Due Process Clause requires a meaningful remedy where taxes have been collected in violation of law and the taxing authority, in this case the Commonwealth, cannot invoke sovereign immunity to relieve itself of that constitutional obligation.

II. The Taxes At Issue Here May Not Be Imposed Retroactively.

Even if the Due Process Clause requires that invalid taxes be remedied, if the taxes at issue in this case were valid in the first place, then of course Appellees' refund claims would evaporate. KRS 141.200(18) seeks to bring about that very result by validating, in effect imposing, taxes after the fact consistent with the position of RP 41P225. The statute purports to retroactively disavow the "unitary business concept" upon which Appellees' amended returns are based, and thus effectively resurrect RP 41P225, the regulation this Court struck down in *GTE*. The Court of Appeals ruled that while some retroactive tax legislation is allowed, the retroactive reach of KRS 141.200(18), which encompasses tax years some five to twelve[7] years before its July 2000 enactment, exceeds what is allowed under the Due Process Clause. The Cabinet maintains that the Court of Appeals read the Due Process Clause too strictly. I disagree.

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[7] The Court of Appeals referred to a retroactivity period of five to nine years, presumably because Appellees' refund claims were for tax years 1990-1994. However, KRS 141.200(18) actually stretched back twelve years to the 1988 adoption of RP 41P225.

A. The Retroactive Reach Of H.B. 541 Is Unreasonable And So Violates The Due Process Clause.

The Supreme Court addressed the issue of retroactive tax legislation in *United States v. Carlton*, 512 U.S. 26 (1994). *Carlton* involved an estate tax provision originally enacted in October 1986 which provided for a deduction when an estate sold stock to an employee stock-ownership plan (ESOP). In December 1986, Carlton, the executor of an estate, used estate funds to purchase stock which he then resold to an ESOP for the express purpose of claiming the estate tax deduction. A week after Carlton filed the estate tax return, the Internal Revenue Service announced that it would seek "clarifying legislation" because the deduction had been intended only for estates where the stock in question was owned by the decedent "immediately before death." Approximately a year after Carlton's stock transactions, Congress amended 26 U.S.C. § 2057 so that it expressly applied only where the decedent had owned the stock at death. The amendment was made retroactive to the date of the original October 1986 enactment. In upholding the amendment the Supreme Court noted that tax legislation is frequently made to apply retroactively to transactions completed earlier in the year of enactment or even in the year prior to enactment. The Court explained that

> [t]he due process standard to be applied to tax statutes with retroactive effect, therefore, is the same as that generally applicable

> to retroactive economic legislation: "Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches. . . . To be sure, . . . retroactive legislation does have to meet a burden not faced by legislation that has only future effects. . . . 'The retroactive aspects of legislation, as well as the prospective aspects, must meet the test of due process, and the justifications for the latter may not suffice for the former'. . . . But that burden is met simply by showing that the retroactive application of the legislation is itself justified by rational legislative purpose."

Id. at 30-31 (quoting from *Pension Benefit Guaranty Corporation v. R.A. Gray & Co.*, 467 U.S. 717, 733 (1984)). The 1987 estate tax amendment passed that test, the *Carlton* Court held, because

> [f]irst, Congress' purpose in enacting the amendment was neither illegitimate nor arbitrary. Congress acted to correct what it reasonably viewed as a mistake in the original 1986 provision that would have created a significant and unanticipated revenue loss. There is no plausible contention that Congress acted with an improper motive, as by targeting estate representatives such as Carlton after deliberately inducing them to engage in ESOP transactions. Congress, of course, might have

chosen to make up the unanticipated revenue loss through general prospective taxation, but that choice would have burdened equally "innocent" taxpayers. Instead, it decided to prevent the loss by denying the deduction to those who had made purely tax-motivated stock transfers. We cannot say that its decision was unreasonable.

Second, Congress acted promptly and established only a modest period of retroactivity. This Court noted in *United States v. Darusmont,* 449 U.S. at 296 [ ], that Congress "almost without exception" has given general revenue statutes effective dates prior to the dates of actual enactment. This "customary congressional practice" generally has been "confined to short and limited periods required by the practicalities of producing national legislation." *Id.* at 296-297 [ ]. In *Welch v. Henry,* 305 U.S. 134, [ ] (1938), the Court upheld a Wisconsin income tax adopted in 1935 on dividends received in 1933. The Court stated that the "'recent transactions'" to which a tax law may be retroactively applied "must be taken to include the receipt of income during the year of the legislative session preceding that of its enactment." *Id.* at 150 [ ]. Here, the actual retroactive effect of the 1987 amendment extended for a period only slightly greater than one year. Moreover, the amendment was proposed by the IRS in January 1987 and by Congress in February 1987, within a few months of § 2057's original enactment.

Id. at 32-33 (emphasis supplied). "Recent transactions," then, may be retroactively taxed, provided that the retroactive application of the statute is itself a reasonable means of furthering a legitimate state purpose. Although the *Carlton* Court refrained from defining "recent transactions" beyond noting that they would include transactions "during the year of the legislative session preceding that of [the retroactive statute's] enactment," the Court's discussion indicates that the length of the retroactivity period is an important factor bearing on the reasonableness of the legislation and that a period much in excess of the one upheld in *Welch* (two years) would raise serious due process concerns.

The Cabinet tries to downplay the prompt legislative response and the limited period of retroactivity in *Carlton,* insisting that neither of those factors is part of the due process analysis, an analysis which should focus solely on whether there is a legitimate legislative purpose.[8] Given the Commonwealth's delay

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[8] As the Court of Appeals aptly stated in its opinion in this case: "The Cabinet argues in vain that there is no "modesty" requirement under *Carlton*." However, many courts interpreting *Carlton* have found such a requirement, including one case explicitly relied upon by the Cabinet. *See Tate & Lyle, Inc. v. C.I.R.*, 87 F.3d 99, 107 (3d Cir. 1996) ("[t]here [in *Carlton*], the Supreme Court set forth a two-part test for determining whether the retroactive application of a tax statute violates due process. First, for retroactivity to be upheld, it must be shown that the statute has a rational legislative purpose and is not arbitrary; and second, that the period of retroactivity is moderate, not excessive.")." Opinion at fn. 32.

of over five years in responding to the *GTE* decision and the long retroactive reach of H.B. 541, it is understandable that the Cabinet would want to minimize these aspects. Unfortunately, a fair reading of *Carlton* does not bear out that position. Central to the *Carlton* decision was the recognition that Congress had not disturbed long-standing transactions because, as Justice O'Connor noted in her concurring opinion, "[t]he governmental interest in revising the tax laws must at some point give way to the taxpayer's interest in finality and repose." 512 U.S. at 37-38.

Here, KRS 141.200(18) offends *Carlton*'s timeliness standard in two ways. First, the statute was not passed promptly but rather five and one-half years after *GTE*. Second, it reaches back from its effective date of July 2000 to income received while RP 41P225 was in effect, from September 1988 until December 1994, a retroactivity period from five-and-a-half years to twelve years. I agree with the Court of Appeals that the state's interest in avoiding the financial consequences of refunds is an inadequate justification for belated legislation with such a long retroactivity period. If the state had *carte blanc* simply to impose retroactive taxes to avoid costly refund claims, then the refund remedy would be rendered uncertain if not entirely meaningless, a result that is clearly unreasonable, and in violation of *Carlton*'s due process standard.

The Cabinet offers two cases in support of its position that retroactive tax legislation can reach

back for an extended period of time, perhaps indefinitely, and still satisfy due process.[9] Neither case supports the unlimited power which the Cabinet attributes to a taxing authority.

In *Montana Rail Link, Inc. v. United States,* 76 F.3d 991 (9th Cir. 1996), a railroad had made tax payments based on the less favorable reading of an ambiguous statute, a provision of the Railroad Retirement Tax Act, which is the functional equivalent of

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[9] The Cabinet also refers in particular to two cases cited in *Carlton, Milliken v. United States,* 283 U.S. 15 (1931) and *Usery v. Turner Elkhorn Mining Co.,* 428 U.S. 1 (1976). Neither of these cases was cited for, or stands for, the proposition that retroactive tax legislation knows no limits. *Milliken* concerned the estate tax of a 1920 decedent's estate. It upheld the application of the 1918 estate-tax rate to a gift in contemplation of death made in 1916. The Court explained that the retroactive application of the 1918 tax-rate increase was a reasonable means of furthering Congress's intent that gifts in contemplation of death be taxed at the same rate as the rest of the decedent's estate. Although the taxpayer did not have notice of the increased rate, this was not a retroactive change apt to upset taxpayer expectations, the Court noted, since estate planners were well aware that gifts in contemplation of death would be taxed at the same rate as the remainder of the estate. The Court did not hold, as the Cabinet suggests, that retroactive taxes are always "reasonable" for due process purposes merely because they serve a State's need for funds. *Usery* was not even a tax case, but a black-lung benefits case, cited in *Carlton* for the proposition that the retroactive aspects of economic legislation must independently satisfy the due process rational basis test. Contrary to the Cabinet's suggestion, it in no way runs contrary to *Carlton*'s clear indication that the length of the retroactivity period is a most important factor bearing on the reasonableness of a retroactive tax.

the Social Security Act for railroad employers. In short, the railroad had mistakenly overpaid. The railroad later sought refunds for 1987 and 1988 based on a more favorable reading suggested by the Railroad Retirement Board. In 1989, while the refund claims were pending, Congress amended the RRTA to resolve the ambiguity in favor of the higher tax and made the amendment retroactive so as to apply to the entire period of the statute's ambiguity, from 1983 through 1989. The amendment thus nullified any refund claims based on the ambiguity. The Ninth Circuit held that the retroactive aspect of the amendment satisfied *Carlton*'s rational basis requirement because a shorter retroactive period would have severely decreased the benefits of some retired railroad workers. Significantly, the *Montana Rail* Court distinguished this situation from cases such as *Reich, supra,* where refund claims were based on taxes found to be illegal:

> At no point did MRL [the railroad] pay any tax barred by the Constitution or federal law. The constitutionality and legality of the RRTA is not in dispute, and MRL does not challenge the legitimacy of taxing 401(k) contributions *per se*. MRL erroneously equates its mistaken overpayment of taxes with the government's "unlawful," "improper" and "erroneous" collection of taxes. Contrary to MRL's assertion, the IRS did not violate any federal law by accepting MRL's overpayment. *Seeking a refund for one's own voluntary overpayment of a lawful tax is not the same*

> *as pursuing a remedy for payment of an illegal tax.*

Id. at 995 (emphasis supplied). *Montana Rail* thus addressed only the retroactive clarification of a valid tax which the taxpayer had voluntarily overpaid through its own misinterpretation of an ambiguous statute. While the Cabinet may find *Montana Rail*'s approval of a clarifying amendment stretching back six years appealing, the Ninth Circuit decision makes clear that it is not addressing the due process issues that arise when a tax has been unlawfully exacted and then retroactive tax laws are passed.

King v. Campbell County, 217 S.W.3d 862 (Ky. App. 2006) involved KRS 68.197, a statute authorizing counties to collect occupational license fees. Although a 1986 amendment to the statute required counties to give taxpayers a credit for city license fees they had paid, Campbell and Kenton Counties maintained that the amendment did not apply to them. Both had adopted occupational license fees in 1978 when the statute required the issue to be placed on the ballot for voter approval and when counties were permitted, but not required, to give taxpayers credit for their city occupational license fees. Only Campbell and Kenton Counties had passed occupational license fees under this older statutory procedure. The Court of Appeals agreed with the counties' interpretation that the amended statute did not require them to give county taxpayers tax credits for city occupational license fees. However, in *City of Covington v. Kenton County,* 149 S.W.3d 358 (Ky.

2004), this Court decided that the amendment did apply to Kenton (and implicitly Campbell too) and thus exposed the county to potentially devastating refund claims for the withheld credits.[10] Almost immediately, in March 2005, the General Assembly amended KRS 68.197 to clarify that Campbell and Kenton Counties were not subject to the city fee credit. The legislation was made retroactive so as to abrogate the *City of Covington* decision and to nullify refund claims based upon it. In *King* the Court of Appeals rejected Campbell County taxpayer challenges to the retroactive legislation. The Court found that the General Assembly had acted promptly, consistent with *Carlton,* to further the legitimate legislative purpose of avoiding severe disruption of county finances and, that the unanticipated *City of Covington* decision had not interfered with "settled expectations" on the part of Campbell County taxpayers, who had acquiesced in the counties' interpretation of the ambiguous statute for years.[11]

> Unlike the amendment in *Carlton,* however, which withdrew an unambiguous deduction and deliberately undermined reasonable taxpayer reliance, House Bill 400

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[10] Under the *City of Covington* rationale, Kenton County owed refunds from 2000 forward. Because Campbell County had imposed higher taxes in 1986, that county's refund obligations would have extended back to 1986. *See King,* 217 S.W.3d at 866.

[11] The Campbell County taxpayers who filed the *King* case waited until *March 2005* to challenge that county's interpretation and seek refunds back to *September 1986.*

does not withdraw a provision upon which taxpayers have relied, but seeks to clarify the license fee credit provision in the wake of our Supreme Court's *City of Covington* decision. The Campbell County taxpayers could have sought refunds in 1986, when Campbell County first raised its license fee rates following the 1986 amendment to KRS 68.197. For all these years, however, the taxpayers acquiesced in the County's interpretation of that statute, an interpretation that this Court found reasonable, but the Supreme Court rejected. If there are "settled expectations" in this case, they are the County's, not the taxpayers. The taxpayers' expectations arose only with the Supreme Court's *City of Covington* decision in November 2004, and within a few short months, in March 2005, long before those expectations could be deemed "settled" or "vested," the General Assembly had acted to revise the law and to shield Campbell and Kenton Counties from what it believed could be the devastating consequences of the Supreme Court's decision. In these circumstances—where the General Assembly has not attempted to withdraw legislation upon which taxpayers have relied in structuring their affairs, but has promptly sought to foreclose refunds as the result of an unanticipated judicial interpretation of a constitutionally valid tax provision—the retroactive provisions of House Bill 400 do not run afoul of the timeliness concerns

> expressed by the United States Supreme Court in *Carlton*.

217 S.W.3d at 870.

The Cabinet understandably focuses on *King* as an example of judicial validation of retroactive tax legislation stretching back for a period well in excess of the modest periods addressed in *Carlton*. *King* is admittedly more akin to the situation before this Court than the mistaken overpayments in *Montana Rail* but there are crucial differences in *King* and this case which bear strongly on the due process analysis.

Campbell and Kenton Counties were the taxing authorities in *King* and *City of Covington* but their taxing authority was constrained by state statute. The counties construed the rather ambiguous statute (which significantly was not of their own making) as inapplicable to them and this construction, as noted above, was acquiesced in by county taxpayers for many years. The reasonableness and good faith of that particular construction, which relieved Campbell and Kenton of the obligation to credit county taxpayers for city occupational fees, was underscored by the fact that the Court of Appeals upheld it. When *City of Covington* was decided, as the Court of Appeals noted, it was an "unanticipated judicial interpretation" of a valid tax. In other words, the counties had interpreted the ambiguous statute passed by the General Assembly in a consistent, plausible way but this Court ultimately found that the taxpayers who eventually had begun to question

the interpretation and who had brought suit to obtain the credits were, in fact, correct. Within four months of that decision, the General Assembly passed a statute that clarified its "original intention" that the tax credit did *not* apply to "those counties where a license fee has been authorized by a public question approved by the voters." In short, the interpretation consistently followed by Campbell and Kenton Counties had been the legislative intent all along.

This case presents a decidedly different scenario. Here, the Cabinet, with the General Assembly's acquiescence, had long construed KRS 141.120 and 141.200 as allowing combined reporting. Only in 1988, without any change in a settled law, did the Cabinet purport to adopt a different construction. In *GTE* this Court held that the Cabinet was not free to say that the statutes meant one thing one day and then the next day to say that they meant something entirely different. Its original reading of those statutes was reasonable, had not been corrected by the General Assembly, and thus was binding. Clearly *King* did not involve the taxing authority suddenly and unilaterally reinterpreting an unchanged tax law to the taxpayers' detriment. Moreover, while *King* arose from "an unanticipated judicial interpretation," *GTE* could not possibly have been unanticipated. Taxpayers challenged the Cabinet's about-face in RP 41P225 promptly and GTE was a return to the precise reading of the statute that the Cabinet itself had engaged in for sixteen years.

Given the long-standing, consistent interpretation of KRS 141.120 to allow combined reporting, KRS 141.200(18) cannot be deemed merely to abrogate *GTE* and to clarify what the law had always been. Like the estate tax amendment in *Carlton*, KRS 141.200(18) is an attempt to alter the tax law retroactively, but unlike the amendment in *Carlton* it purports to apply the change not just to recent transactions but to transactions (the receipt of income) in tax years from five years to twelve years earlier. Although I recognize the General Assembly's desire to spare the state's budget from the significant refund claims springing from the Cabinet's unauthorized 1988 rereading of KRS 141.120 and 141.200, I agree with the Court of Appeals that this five-year plus backward reach, particularly on these facts, exceeds what the Supreme Court has indicated is reasonable under the Due Process Clause and thus cannot be upheld. Simply put, difficult economic consequences can never justify disregarding citizens' due process rights.

B. *GTE* Was Not Wrongly Decided.

Finally, if the General Assembly could not retroactively ratify RP 41P225 more than five years after *GTE*, the Cabinet urges this Court to do so itself by revisiting and over-ruling our decision in *GTE*. *GTE* was wrongly decided, the Cabinet insists, because notwithstanding its own sixteen-year policy of permitting combined reports, KRS Chapter 141 in fact precluded such reports at all times, and thus RP

41P225 embodied an accurate construction of the law. The Cabinet's invitation to indulge in such revisionism should be rejected, not simply because of *stare decisis*, but because *GTE* was right.

The Cabinet focuses first on KRS 141.200(1). From before 1966, when the General Assembly adopted UDITPA, until the amendments of 1996, that statute provided that "[e]very corporation doing business in this state, except those exempt from taxation under KRS 141.040, shall make a return stating specifically the items of income and the items claimed as deductions allowed by this chapter. Corporations that are affiliated must each make a separate return." In that timeframe, the General Assembly had not defined either "affiliated" or "corporations that are affiliated," and without some definition the second sentence is ambiguous. It can mean either "each corporation within an affiliation must file a separate return," or "each corporate affiliation must file a separate return." For years, as noted, the Cabinet had in effect applied the second reading and, understanding "affiliated" to include "unitary" corporations, had permitted combined reports. In *GTE*, we held that the Cabinet's settled reading was not unreasonable and thus could not be abandoned merely to suit its own change of policy. Such a change would need to come from the General Assembly. The Cabinet insists that its prior reading of the statute was not reasonable, and that we erred by holding that it was. This disingenuous argument does not provide a sufficient reason to revisit *GTE*.

The fact remains that for sixteen years, with the apparent blessing of the General Assembly, the Cabinet construed KRS 141.200 to permit combined reports. That settled construction cannot be undone by the Cabinet merely because an ambiguous phrase might initially have been read a different way. This Court did not err in *GTE* by so holding.

The Cabinet also contends that statutory uses of the term "corporation," are couched in the singular and thus imply a legislative intent that only separate corporations be taxed. In general, however, statutory singulars are understood as referring as well to plurals. KRS 446.020. As noted above, moreover, combined reporting does not involve disregarding separate corporate entities to produce one comprehensive return but rather is an accounting method by which each corporation in a unitary business accounts for its respective share of the unitary entity's income. *See* Sutton, "Comparison of Group Reporting Methods," *supra.* In conjunction with formulary apportionment, combined reporting allows for determination of that portion of the unitary business's income attributable to the taxing state. *Id.* That the statutes refer to "corporation" in the singular, therefore, does not suggest that combined reports had been ruled out. Indeed, also as noted above, KRS 141.205 expressly required "combined returns" in certain circumstances, a clear indication that the General Assembly did not intend to preclude them.

Nor was combined reporting ruled out by the fact that prior to *GTE* the calculation of taxable income in Kentucky began with gross income as determined for federal tax purposes. Combined reporting merely considers together the duly calculated incomes of unitary corporations. It did not require a calculation of income at odds with the statutory definitions, as clearly indicated, by KRS 141.205's provision for combined reports. Again, then, the Cabinet has not shown that its own reading of the statutes from 1972 until 1988 was unreasonable or contrary to their plain intent, and thus *GTE* correctly held that that reading was not to be cast aside without legislative direction.

CONCLUSION

In sum, I agree with the Court of Appeals that both KRS 141.200(17) and 141.200(18) violate the Due Process Clause and so may not be enforced. KRS 141.200(17) unlawfully withdraws the remedy the state is obliged to provide for illegally collected taxes, and KRS 141.200(18) retroactively imposes a tax beyond the period the Supreme Court has indicated is reasonable. Accordingly, I would affirm the May 5, 2006 Opinion of the Court of Appeals and so respectfully dissent from the majority's contrary ruling.

Cunningham, J., joins.

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Commonwealth Of Kentucky

Court of Appeals

NO. 2004-CA-001566-MR

JOHNSON CONTROLS, INC.; SECURITY GROUP, INC. AND SUBSIDIARIES, INCLUDING SARGENT & GREENLEAF, INC., WILLIS NORTH AMERICA, INC. (F/K/A WILLIS CORROON CORPORATION) AND AFFILIATES; BUNZL USA, INC. AND SUBSIDIARIES, INCLUDING MAK-PAK, INC., TREDEGAR CORPORATION AND SUBSIDIARIES, PREDECESSOR IN INTEREST TO TREDEGAR INDUSTRIES, INC. AND SUBSIDIARIES; AND COSMOS BROADCASTING CORPORATION AND AFFILIATES — APPELLANTS

APPEAL FROM FRANKLIN CIRCUIT COURT
v. HONORABLE WILLIAM L. GRAHAM, JUDGE
CIVIL ACTION NOS. 00-CI-00523 AND 00-CI-00661

ROBBIE RUDOLPH, THE CURRENT SECRETARY OF THE FINANCE AND ADMINISTRATION CABINET, REVENUE DEPARTMENT; AND COMMONWEALTH OF KENTUCKY, FINANCE AND ADMINISTRATION CABINET, REVENUE DEPARTMENT — APPELLEES

OPINION REVERSING AND REMANDING

** ** ** ** **

BEFORE: BARBER, MINTON, AND TACKETT, JUDGES.

MINTON, JUDGE:

I. INTRODUCTION.

While the Appellants' administrative claims for income tax overpayment languished in the Kentucky Revenue Cabinet, the 2000 session of the Kentucky General Assembly enacted H.B. 541, which nullified these claims. Appellants then filed declaratory judgment actions in circuit court seeking to have the subsection of Kentucky Revised Statutes Chapter (KRS) 141.200 that codified H.B. 541 declared unconstitutional. Before us is the appeal from the unsuccessful declaratory judgment actions. We hold that the retroactivity period created by H.B. 541 exceeds the constitutional limits and violates Appellants' due process rights. Therefore, we reverse the circuit court.

II. FACTUAL BACKGROUND AND PROCEDURAL HISTORY.

Beginning in 1972, the Cabinet allowed unitary businesses to file combined or unitary tax returns.[1]

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[1] *See GTE v. Revenue Cabinet,* 889 S.W.2d 788, 790 (Ky. 1994). A "unitary business" is defined as "[a] business that has

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For reasons unnecessary to the resolution of this appeal, in 1988, the Cabinet issued a policy statement that "effectively halted the filing of combined [unitary] returns."[2] GTE challenged the Cabinet's policy shift in a case that reached the Kentucky Supreme Court in 1994.

On December 22, 1994, the Kentucky Supreme Court decided in GTE's favor, permitting unitary businesses to resume the practice of filing unitary tax returns in Kentucky. In response to that decision, Appellants, twenty-six businesses that claim to be legally entitled to file unitary tax returns, each filed amended tax returns with the Cabinet seeking reimbursement for taxes they claimed to have overpaid during the period that the Cabinet's policy prevented them from filing unitary tax returns.[3] Although the Cabinet purportedly acted on the overpayment requests of other similarly situated businesses, it took no immediate action on Appellants' claims.

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subsidiaries in other states or countries and that calculates its state income tax by determining what portion of a subsidiary's income is attributable to activities within the state, and paying taxes on that percentage." BLACK'S LAW DICTIONARY (8th ed. 2004). Similarly, a "unitary tax" is "[a] tax of income earned locally by a business that transacts business through an affiliated company outside the state or country." *Id.*

[2] *GTE*, 889 S.W.2d at 790.

[3] *See* KRS 134.580, which authorizes refunds to any taxpaying entity for tax overpayments, provided that the refund application was made within four years from the date the payment was made.

At its next regular session following the *GTE* decision, 1996, the General Assembly enacted H.B. 599, which abolished unitary returns for the tax years after December 31, 1995. But that legislation had no effect on Appellants' pending claims for repayment. These claims were still pending before the Cabinet when the General Assembly convened its 1998 regular session. In that session, the General Assembly enacted H.B. 321. That bill did not retroactively nullify Appellants' pending claims. Rather, the statute only provided that no post-*GTE* repayment claims would be paid during the biennial budget period. In court action challenging H.B. 321, the Franklin Circuit Court declared it unconstitutional, a decision the Cabinet appealed to this Court. But before this Court could decide the appeal, H.B. 321 expired by its own terms; and we dismissed the appeal as moot.[4]

Appellants' claims for overpayment were actively pending with the Cabinet when the General Assembly convened for its 2000 session. The General Assembly, apparently alarmed that the appellants' pending claims could significantly drain the state's

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[4] The facts regarding bills passed by the General Assembly in 1996 and 1998 is [sic] largely drawn from Appellants' motion for summary judgment before the trial court. To the extent that any factual recitations are disputed, they are presented in the light most favorable to Appellants, the party against whom summary judgment was granted. *See Steelvest, Inc. v. Scansteel Service Center, Inc.*, 807 S.W.2d 476, 480 (Ky. 1991) (citing *Paintsville Hosp. Co. v. Rose*, 683 S.W.2d 255 (Ky. 1985)).

treasury, enacted H.B. 541, which substantially amended KRS 141.200. Specifically, after enactment of H.B. 541, KRS 141.200(9)[5] provided that

> [n]o claim for refund or credit of a tax overpayment for any taxable year ending on or before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return, shall be effective or recognized for any purpose.

Similarly, after the enactment of H.B. 541, KRS 141.200(10)[6] provided that

> [n]o corporation or group of corporations shall be allowed to file a combined return under the unitary business concept or a consolidated return for any taxable year ending before December 31, 1995, unless on or before December 22, 1994, the corporation or group of corporations filed an initial or amended return under the unitary business concept or consolidated return for a taxable year ending before December 22, 1994.

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[5] Although it was not substantively amended, KRS 141.200(9) was recodified as KRS 141.200(17) after the filing of this action.

[6] Although it was not substantively amended, KRS 141.200(10) was recodified as KRS 141.200(18) subsequent to the filing of this action.

The effect of H.B. 541 was to extinguish retroactively Appellants' pending claims for tax overpayment.

Arguing H.B. 541 to be unconstitutional, Appellants filed two separate declaratory judgment actions in the Franklin Circuit Court to have the retroactive portions of that law declared unconstitutional. Those two cases were consolidated; and the circuit court granted summary judgment to the Cabinet, expressly finding that H.B. 541 was not unconstitutional. The Appellants have appealed that ruling to this Court.

III. DISCUSSION AND ANALYSIS.

A. Propriety of Dual Administrative and Declaratory Judgment Proceedings.

Initially, we were concerned about whether this appeal was properly before us because the Appellants filed their declaratory judgment actions while their administrative claims for tax overpayment were pending. Normally, such parallel actions regarding the same subject matter and parties are potentially problematic because, generally speaking, a party seeking to have a statute declared unconstitutional must show that the application of the statute has caused injury.[7] At the time these declaratory judgment

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[7] *Commonwealth v. DLX, Inc.*, 42 S.W.3d 624, 626 (Ky. 2001) ("[i]n other words, until a statute has been applied, there can be no unconstitutional application. This is the basis for the rule that one must first show injury as the result of a statutory

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actions were filed in circuit court, the Appellants had suffered no harm from the application of KRS 141.200 because neither the Cabinet nor the Kentucky Board of Tax Appeals had relied upon that statute to deny Appellants' overpayment claims. And it appeared to us that the Appellants should have exhausted their administrative remedies[8] by finishing the proceedings before the Cabinet and Board of Tax Appeals before proceeding in circuit court.[9] So in order to allay our concerns and to broaden our understanding of the parties' positions, we asked for supplemental briefs. And after having examined those briefs and considering oral arguments, we have decided that

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application, before that application may be attacked as unconstitutional.").

[8] *See, e.g., Board of Regents of Murray State Univ. v. Curris*, 620 S.W.2d 322, 323 (Ky.App. 1981) ("[s]ubject to limited exceptions, none of which are present in this case, exhaustion of administrative remedies must precede judicial review of an administrative agency's action. Thus, even though the court had subject-matter jurisdiction, proper judicial administration mandates judicial deference until after exhaustion of all viable remedies before the agency vested with primary jurisdiction over the matter."); *DLX*, 42 S.W.3d at 625 ("[a]s a general rule, exhaustion of administrative remedies is a jurisdictional prerequisite to seeking judicial relief.").

[9] KRS 131.370(1) provides, in relevant part, that "[a]ny party aggrieved by any final order of the Kentucky Board of Tax Appeals . . . may appeal to the Franklin Circuit court or to the Circuit Court of the county in which the party aggrieved resides or conducts his place of business in accordance with KRS Chapter 13B."

exhaustion of administrative remedies is not required under these unique facts.

It is well settled that administrative bodies, such as the Cabinet and the Board of Tax Appeals, lack the power to declare a statute unconstitutional.[10] Thus, exhaustion of administrative remedies is not required when a statute is challenged as being unconstitutional on its face.[11] As the parties' supplemental briefs make clear, Appellants raise a facial challenge to KRS 141.200's constitutionality. So the exhaustion of administrative remedies doctrine is inapplicable, meaning that the Appellants were free to file their declaratory judgment actions in circuit court before the termination of their administrative claims with the Cabinet.[12] Likewise, since the administrative bodies lacked the power to declare KRS 141.200 unconstitutional, it would have been futile for the Appellants to seek that type of relief from those bodies. So this case also fits within the futility exception to the exhaustion of administrative remedies requirement.[13] Satisfied that no procedural impediment exists, we may examine this appeal on its merits.

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[10] *DLX*, 42 S.W.3d at 626.

[11] *Id.*

[12] *Kentucky Retirement Systems v. Lewis*, 163 S.W.3d 1, 3 (Ky. 2005) ("a party is not required to exhaust all administrative remedies when the statute is alleged to be void on its face.").

[13] *Id.* ("[e]xhaustion of remedies is likewise not required when continuation of an administrative process would amount to an exercise in futility.").

B. Standard of Review.

In assessing the propriety of the trial court's grant of summary judgment to the Cabinet, we recognize that summary judgment was appropriate only if the Cabinet showed that Appellants "could not prevail under any circumstances."[14] In ruling on a motion for summary judgment, the trial court must view the evidence in the light most favorable to the party opposed to the motion.[15] And when we review a trial court's decision to grant summary judgment, we must determine whether the trial court correctly found that there were no genuine issues of material fact.[16] Since findings of fact are not at issue here, the trial court's decision is entitled to no deference.[17]

Since Appellants are challenging the constitutionality of a statute, we must bear in mind that "[i]t is by now well established that legislative Acts adjusting the burdens and benefits of economic life come to the Court with a presumption of constitutionality. . . ."[18] In Kentucky, "[t]he test of the constitutionality of a statute is whether it is unreasonable or

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[14] *Steelvest*, 807 S.W.2d at 480.

[15] *Id.*

[16] *Scifres v. Kraft*, 916 S.W.2d 779, 781 (Ky.App. 1996).

[17] *Id.*

[18] *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 15 (1976). Accord *Buford v. Commonwealth*, 942 S.W.2d 909, 911 (Ky.App. 1997) ("[a] strong presumption exists in favor of the constitutionality of a statute.").

arbitrary."[19] Finally, a statute is constitutionally valid "if a reasonable, legitimate public purpose for it exists, whether or not we agree with its 'wisdom or expediency.' "[20]

C. Is H.B. 541 Special Legislation?

Appellants' first main argument is that H.B. 541 is special legislation that violates Section 59 of the Kentucky Constitution. That section prohibits the General Assembly from passing any "local or special acts" regarding, among other things, "the assessment or the collection of taxes . . .

According to Appellants, once H.B. 541 was enacted in 2000, the four-year time limit of KRS 134.580 for filing tax overpayment requests for 1995 and any preceding years had already elapsed. So no other entities could have legally sought relief for any alleged overpayment occurring before December 31, 1995. And since they were the only entities with pending and unresolved overpayment claims for years preceding 1995, Appellants contend that H.B. 541's sole purpose was to destroy their pending overpayment claims through retroactive legislation.

Generally, "the term 'special law' is legislation which arbitrarily or beyond reasonable justification

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[19] *Buford*, 942 S.W.2d at 911.

[20] *Id.* (quoting *Walters v. Bindner*, 435 S.W.2d 464, 467 (Ky. 1968)).

discriminates against some persons or objects and favors others."[21] But legislation is not "special legislation" simply because it does not directly apply to every person in the Commonwealth.[22] Rather, in order to be special legislation, the law must apply disparately within the class of people to whom it was directed. In other words,

> [l]aws which apply to and operate uniformly upon all members of any class of persons, places, or things, requiring legislation peculiar to themselves in the matters covered by the laws in question, are general and not special. Laws which are framed in general terms and are not restricted in locality, but operate equally upon all groups of objects, which having regard to the purpose of the legislation or distinguished by characteristics sufficiently marked and important to make them a class by themselves, are declared . . . to be general.[23]

So "in order for a law to be general in its constitutional sense it must meet the following requirements: (1) It must apply equally to all in a class, and (2) there must be distinctive and natural reasons

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[21] *City of Louisville v. Klusmeyer*, 324 S.W.2d 831, 834 (Ky. 1959).

[22] *Commonwealth v. Moyers*, 272 S.W.2d 670, 673 (Ky. 1954) ("[a] law is not local or special merely because it does not relate to the whole state or to the general public.").

[23] *King v. Commonwealth*, 194 Ky. 143, 238 S.W. 373, 376 (1922).

inducing and supporting the classification."[24] This describes the two-pronged *Schoo* test that is used as the benchmark for determining whether legislation is special or general.

As for the first *Schoo* prong, the portions of KRS 141.200 at issue are, on their face, applicable to any business or corporate entity desiring to file an amended return based on the switch to the unitary filing method, provided that this switch occurred after December 22, 1994. Thus, H.B. 541 is not special legislation because it "uniformly operates on and applies to all persons and claims within its scope and range."[25] The fact that only a small group of taxpayers is potentially affected by the legislation does not mean that the legislation is special legislation.[26]

The second prong of the *Schoo* test is also satisfied. The clear reason underlying the General Assembly's passage of H.B. 541 was to forestall a loss of funds from the state treasury. Raising or preserving state revenues is a legitimate legislative

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[24] *Schoo v. Rose*, 270 S.W.2d 940, 941 (Ky. 1954).

[25] *Commonwealth v. McCoun*, 313 S.W.2d 585, 588 (Ky. 1958).

[26] *Kentucky Milk Marketing and Anti-Monopoly Commission v. The Borden Co.*, 456 S.W.2d 831, 835 (Ky. 1969) ("[i]n any event the fact that a legislative act deals with a special subject does not make it special legislation. All acts must deal with a special subject, such as alcoholic beverages, game and fish, conduct of elections, etc.").

goal.[27] Choosing December 22, 1994, as the cutoff date for switching to a unitary tax return enabled the General Assembly, in its collective wisdom, a way to avoid depleting the state treasury. Thus, H.B. 541 was rationally related to effectuating its permissible purpose. Overall, therefore, we find that H.B. 541 is not special legislation.

D. Does H.B. 541 Violate the Due Process Clause?

Appellants' second main argument is that H.B. 541's retroactive effect deprives them of due process. Because of the excessive period of retroactivity contained in that law, we agree.

Retroactive periods in legislation are nothing new. In fact, the United States Supreme Court "repeatedly has upheld retroactive tax legislation against a due process challenge."[28] So the fact that H.B. 541 acts retroactively does not, in and of itself, make it unconstitutional.

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[27] *See, e.g., United States v. Carlton*, 512 U.S. 26, 40 (Scalia, J., concurring) ("[r]evenue raising is certainly a legitimate legislative purpose. . . .") *See also, e.g., Wilson v. Gipson*, 753 P.2d 1349, 1351-1352 (Okla. 1988) ("[i]t is within the legitimate power of the legislature to take steps to preserve sufficient public funds to ensure that the government will be able to continue to provide those services which it believes benefits the citizenry.").

[28] *Carlton*, 512 U.S. at 30. *See also Usery*, 428 U.S. at 16 ("[b]ut our cases are clear that legislation readjusting rights and burdens is not unlawful solely because it upsets otherwise settled expectations.").

According to *United States v. Carlton,* the seminal case in this area, "[t]he due process standard to be applied to tax statutes with retroactive effect . . . is the same as that generally applicable to retroactive economic legislation[.]"[29] Thus, the overarching test used to analyze such legislation is the familiar rational basis test.[30]

In order to determine if a retroactive tax statute passes the rational basis test, however, the *Carlton* court set forth a two-part test. First, it looked at the statute to find if it was arbitrary or was enacted for a legitimate purpose.[31] Second, it focused on whether the act was promptly enacted and "established only a modest period of retroactivity."[32]

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[29] *Carlton* at 512 U.S. at 30.

[30] *Id.* at 30-31 (quoting *Pension Benefit Guaranty Corporation v. R.A. Gray & Co.,* 467 U.S. 717, 729-730 (1984) (internal quotation marks omitted) ("[p]rovided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches.").

[31] *Id.* at 32 ("[w]e conclude that the 1987 amendment's retroactive application meets the requirements of due process. First, Congress' purpose in enacting the amendment was neither illegitimate nor arbitrary.").

[32] *Id.* The Cabinet argues in vain that there is no "modesty" requirement under *Carlton.* However, many courts interpreting *Carlton* have found such a requirement, including one case explicitly relied upon by the Cabinet. *See Tate & Lyle, Inc. v. C.I.R.,* 87 F.3d 99, 107 (3d Cir. 1996) ("[t]here [in *Carlton*], the Supreme Court set forth a two-part test for determining whether

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As noted in our discussion of whether H.B. 541 was special legislation, the General Assembly's purported purpose in enacting the statute was to avoid the potential loss of revenue caused by filing amended returns on a unitary basis for years before 1995. The statute is rationally related to accomplishing that legitimate purpose, and whether we believe the statute was the wisest or the best method of accomplishing that purpose is irrelevant to our inquiry.

But we are constrained to find that the period of retroactivity contained in H.B. 541 is so lengthy as to constitute a due process violation. We are well aware that because H.B. 541 scuttled what Appellants considered to be their right under formerly established law to receive reimbursement for overpayment is, in and of itself, of no consequence as "[t]ax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code."[33] But, at some point, the rights of a taxpayer to proceed under particular

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the retroactive application of a tax statute violates due process. First, for retroactivity to be upheld, it must be shown that the statute has a rational legislative purpose and is not arbitrary; and second, that the period of retroactivity is moderate, not excessive.").

[33] *Carlton*, 512 U.S. at 33. Similarly, under Kentucky law "[i]t is generally recognized that the right to a refund of illegally or improperly collected taxes does not derive from the common law, but is a matter of legislative grace." *Dept. of Conservation v. Co-De Coal Co.*, 388 S.W.2d 614, 615 (Ky. 1965). And it is clear that matters of legislative grace may be "granted, withdrawn or restricted at the will of the legislature." *Univ. of Kentucky v. Guynn*, 372 S.W.2d 414, 416 (Ky. 1963).

provisions of a taxation code become settled enough so that a taxpayer must be permitted to order his financial affairs in regards to those laws.[34] Thus, the Supreme Court opined in *Carlton* that the period of retroactivity must be "modest."

No hard and fast rule exists for what is or is not a permissibly modest period of retroactivity. But our research has shown that nearly all of the post-*Carlton* reported cases[35] involve challenges to statutes containing retroactive periods of less than one year.[36]

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[34] *See Carlton*, 512 U.S. at 37-38 (O'Connor, J., concurring) ("[t]he governmental interest in revising the tax laws must at some point give way to the taxpayer's interest in finality and repose.").

[35] Unfortunately, no Kentucky appellate court has had occasion to cite *Carlton*. Thus, we must turn to the decisions of the federal courts and our sister state courts for guidance.

[36] Indeed, although the majority did not expressly adopt her rationale, Justice O'Connor's concurring opinion in *Carlton* sets forth a bright line one-year limitation on the permissible period of retroactivity for a taxation statute. *Carlton*, 512 U.S. at 38 (O'Connor, J., concurring) ("[a] period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions."). In fact, even though *Carlton* first explicitly set forth the modesty requirement, the federal courts have previously expressed concern regarding tax statutes with periods of retroactivity longer than one year. *See, e.g., U.S. v. Darusmont*, 449 U.S. 292, 296-297 (1981) (holding that the permissible period of retroactivity for federal taxation statutes "has been confined to short and limited periods required by the practicalities of producing national legislation."). Surprisingly, the estimable judge Learned Hand expressed concern about periods of retroactivity exceeding twelve months as far back as 1930.

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In the case at hand, the period of retroactivity is over five years because H.B. 541 was enacted in 2000 and purports to take away tax returns filed as of December 1994.[37]

We have examined the cases relied upon by both the trial court and the Cabinet in favor of H.B. 541. Of those cases, only three were decided after *Carlton* enunciated the modesty doctrine for retroactive tax legislation.[38] So those three are most relevant to the issue at hand.

Of those three cases, two involve challenges to retroactive administrative regulations promulgated by the United States Treasury Department and Internal Revenue Service.[39] Thus, as those cases do not involve statutes, they are easily distinguishable from the case at hand. That distinction is further highlighted by the fact that the administrative agencies involved in those two cases apparently had

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Cohan v. Commissioner of Internal Revenue, 39 F.2d 540, 545 (2d Cir. 1930). ("Nobody has a vested right in the rate of taxation, which may be retroactively changed at the will of Congress at least for periods of less than twelve months; Congress has done so from the outset.")

[37] As Appellants filed for refund of overpayments for the four years preceding the *GTE* decision, H.B. 541's period of retroactivity is actually from about five to about nine years.

[38] *See Montana Rail Link, Inc. v. U.S.*, 76 F.3d 991 (9th Cir. 1996); *Tate & Lyle, Inc.*, 87 F.3d 99; *A. Tarricone, Inc. v. U.S.*, 4 F.Supp.2d 323 (S.D.N.Y. 1998).

[39] *Tate & Lyle, Inc.*, 87 F.3d 99; *A. Tarricone, Inc.*, 4 F.Supp.2d 323.

the discretionary power to determine the retroactive effects of tax regulations.[40] So the only relevant authority relied upon by the Cabinet is *Montana Rail Link, Inc.*

Montana Rail Link, Inc. is distinguishable from the case at hand for two main reasons. First, *Montana Rail Link, Inc.* contains no discussion of whether the retroactivity period in its challenged statute is

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[40] *A. Tarricone, Inc,* 4 F.Supp.2d at 326 ("[w]hile retroactive application of a statute is disfavored, a federal agency will have the power to promulgate retroactive rules if 'that power is conveyed by Congress in express terms.' *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (1988). At the time in question, Congress had expressly conveyed that power to the Secretary of the Treasury: The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect. 26 U.S.C. § 7805(b) (West 1989)"); *Tate & Lyle, Inc.*, 87 F.3d at 107 ("[b]ased on the Supreme Court's holding in *Carlton,* the Tax Court found the six year period in this case excessive, and thus, violative of the Due Process Clause. We find, however, that Carlton is distinguishable: *Carlton* involved the retroactive application of a *statute*, and here we are dealing with the retroactive application of a *regulation*. The retroactivity of treasury regulations is governed by I.R.C. § 7805(b), which states:

> The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.
>
> Clearly Congress has determined that treasury regulations are presumed to apply retroactively. The extent to which newly promulgated regulations shall not apply retroactively is a matter of discretion left to the Secretary.") (Footnote omitted.) (Emphasis in original.).

modest, as is required by *Carlton*. Second, the statute at issue in *Montana Rail Link, Inc.* was primarily focused on protecting the rights of retired railroad workers, whereas, the General Assembly in our case was solely concerned with protecting state funds. Thus, we find that *Montana Rail Link, Inc.* is an insufficient basis to support H.B. 541's retroactivity period.

The five- to nine-year retroactivity period enacted in H.B. 541 appears to be greater than that approved for any similar statute by a court in the *post-Carlton* era. Although we recognize that enactments of the General Assembly are entitled to deference, that deference is not so unlimited as to permit the General Assembly to delay five to nine years to settle claims of Kentucky taxpayers. Had the General Assembly enacted H.B. 541 in 1996, at its first session following the *GTE* decision, the outcome of this appeal may well have been different. But as it stands, the Cabinet is asking us to approve a statute with a potential period of retroactivity far in excess of any approved since *Carlton*.

We agree with the Supreme Court of South Carolina's learned opinion that "[a]t some point . . . the government's interest in meeting its revenue requirements must yield to taxpayers' interest in finality regarding tax liabilities and credits. That point has been reached in this case; under the facts and circumstances here, the retroactivity period is

simply excessive."[41] In short, we find that the portions of H.B. 541 currently codified at KRS 141.200(17)-(18) are an unconstitutional infringement upon Appellants' due process rights.

In reaching our decision, we reject the Cabinet's sovereign immunity defense. It is settled law that a taxing entity must provide a post-deprivation remedy for a taxpayer aggrieved by an unconstitutional statute. In *McKesson Corp. v. Div. of Alcoholic Beverages and Tobacco,* the United States Supreme Court held that

> [i]f a State places a taxpayer under duress promptly to pay a tax when due and relegates him to a postpayment refund action in which he can challenge the tax's legality, the Due Process Clause of the Fourteenth Amendment obligates the State to provide

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[41] *Rivers v. State,* 490 S.E.2d 261, 265 (S.C. 1997) (striking down tax legislation with two to three year period of retroactivity on due process grounds). *See also City of Modesto v. National Med, Inc.,* 27 Cal.Rptr.3d 215, 222 (Cal.Ct.App. 2005) (striking down a municipal business license tax because "the period of retroactivity sought by the City is not 'modest.' The 2004 guidelines would be applied to the 1996 through 2000 tax years, up to eight years before those guidelines were adopted. Generally in California, courts have upheld the retroactive application of tax laws only where such retroactivity was limited to the current tax year. As noted by Justice O'Connor, concurring in *United States v. Carlton,* a period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise serious constitutional issues.") (Internal citation omitted.).

> meaningful backward-looking relief to rectify any unconstitutional deprivation.[42]

And in *Revenue Cabinet v. Gossum*, our Supreme Court held that

> Kentucky's system is structured so that a taxpayer is coerced into paying the tax in advance to avoid financial sanctions. The Supreme Court has held [in *McKesson Corp.*] that in such cases the due process clause of the Fourteenth Amendment obligates the state to provide *meaningful* backward-looking relief to rectify any unconstitutional deprivation.[43]

Thus, Kentucky must provide a method for Appellants to receive any funds they improperly paid under the unconstitutional portions of H.B. 541, which it has done under the tax refund statutes codified at KRS 134.580 and 134.590. Nevertheless, the Cabinet contends that H.B. 541 contains a withdrawal of the Commonwealth's waiver of sovereign immunity contained in those tax refund statutes. Upholding the Cabinet's sovereign immunity claim would, therefore, improperly extinguish Appellants' clear right to seek a post-deprivation remedy.

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[42] 496 U.S. 18, 31 (1990) (internal footnote omitted) (emphasis in original).

[43] 887 S.W.2d 329, 332 (Ky. 1994) (emphasis in original).

E. Other Constitutional Issues.

Because we have found that the challenged portions of H.B. 541 violate Appellants' due process rights, we will not belabor this opinion by engaging in a detailed analysis of the remainder of Appellants' supplemental arguments. But we will briefly address them because of the importance of this case.

Like their due process claim, Appellants' equal protection argument is also analyzed under the rational basis test, albeit without any apparent requirement that the period of retroactivity be modest.[44] We have already determined that H.B. 541 is rationally related to the legitimate governmental interest of preserving previously collected revenue. Thus, Appellants' equal protection argument must fail.

Appellants next claim that H.B. 541 represents a violation of the separation of powers contained in

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[44] *See Stephens v. State Farm Mutual Auto. Ins. Co.*, 894 S.W.2d 624, 627 (Ky. 1995) (holding that a statue does not "violate the equal protection clause merely because the classifications made by its laws are imperfect. The uniformity principle is not violated nor is the equal protection of laws violated if there is a reasonable basis or rational justification. When the objective is legitimate and the classification is rationally related to that objective, it is not constitutionally arbitrary."); *Weiand v. Board of Trustees of Kentucky Retirement Systems*, 25 S.W.3d 88, 92 (Ky. 2000) ("[a]s a general rule, a statute is presumed valid and will survive an equal protection challenge if it can be shown that the classification drawn by the statute is rationally related to a legitimate state interest.").

sections 27 and 28 of the Kentucky Constitution because, in enacting that legislation, the General Assembly retroactively overruled *GTE*. We reject this argument. Clearly, the General Assembly possesses the exclusive power to write and amend Kentucky's tax code.[45] Furthermore, the General Assembly possesses the unquestioned right to take action in response to decisions of Kentucky courts.[46] Thus, the General Assembly did not violate the Kentucky Constitution's separation of powers doctrine when it enacted H.B. 541 in response to *GTE*.

We express no opinion on Appellants' arguments that H.B. 541 violates the "takings clauses" of the federal and Kentucky Constitutions which prohibit the taking of private property for public use. Appellants' brief clearly provides that they are advancing their takings argument only if H.B. 541 is found to be constitutionally sound, which it is not.[47]

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[45] *Commonwealth, ex rel. Armstrong v. Collins*, 709 S.W.2d 437, 448 (Ky. 1986) ("[t]he General Assembly has the basic constitutional power and responsibility to tax and to spend the public's money. This power, as we have seen in prior decisions, is exclusive to the General Assembly and includes the power to use a budget bill to repeal, amend, modify and suspend existing statutes.").

[46] *Telamarketing Communications, Inc. v. Liberty Partners*, 798 S.W.2d 462, 463 (Ky. 1990) ("[t]he General Assembly has a perfect right to change the common law and previous court decisions. . . .").

[47] *See* Appellants' Brief, p. 23 ("[a]lternatively, should this Court rule finds [sic] that H.B. 541 is constitutional, that

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Finally, we also express no opinion on Appellants' argument that H.B. 541 violates Section 51 of the Kentucky Constitution, which requires the republication of any previously enacted legislation amended by a new statute. Appellants did not raise this argument before the trial court. Thus, it is not cognizable on appeal.[48]

IV. CONCLUSION.

Because the retroactivity period of H.B. 541 is so excessive as to violate due process, the trial court's order granting summary judgment to Appellees is reversed and this matter is remanded for further proceedings consistent with this opinion. Lest this opinion be misconstrued, we are not stating that Appellants are entitled to relief in their pending claims for tax overpayments. Rather, we only hold that they are entitled to receive a full, final, and prompt resolution of those claims on their merits.

ALL CONCUR.

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provision works a taking of the Appellants['] refund claim and associated monies.").

[48] *Hutchings v. Louisville Trust Co.*, 276 S.W.2d 461, 466 (Ky. 1955) ("[i]n the first place, it is the accepted rule that a question of law which is not presented to or passed upon by the trial court cannot be raised here for the first time.").

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COMMONWEALTH OF KENTUCKY
FRANKLIN CIRCUIT COURT
DIVISION II
CIVIL ACTION NO. 00-CI-00523
CIVIL ACTION NO. 00-CI-00661

JOHNSON CONTROLS, INC., ET AL.

PLAINTIFFS

v. **OPINION AND ORDER**

COMMONWEALTH OF KENTUCKY, REVENUE CABINET, ET AL.

DEFENDANTS

* * *

This matter is before the Court on the parties' Cross-Motions for Summary Judgment. The Court, having considered the arguments, and being otherwise sufficiently advised, makes the following findings.

I. Background

The Plaintiffs comprise several corporations that pay taxes collected by the Defendant, Kentucky's Revenue Cabinet ("the Cabinet"). The Plaintiffs contend that the Cabinet and Kentucky's General Assembly unlawfully denied their ability to obtain tax refunds. To understand the Plaintiffs' complaint, a review of the parties' actions is necessary.

From at least 1972 until 1988, the Cabinet interpreted KRS 141.120 to allow corporations to file

unitary tax returns. In 1988 the Cabinet changed its interpretation by adopting Revenue Policy 41P225. The policy prohibited the filing of unitary returns and required separate returns. Tax instructions for tax years 1990 to 1993 informed taxpayers of the prohibition, but the Cabinet accepted unitary and separate returns in 1993. Several corporations challenged Revenue Policy 41P225, and on December 22, 1994, the Kentucky Supreme Court struck it down in *GTE v. Revenue Cabinet*, Ky., 889 S.W.2d 788 (1994).

After *GTE* the Cabinet believed that KRS 141.120 required unitary returns. Taxpayers who originally filed separate returns, such as the Plaintiffs, amended their returns by filing unitary returns.[1] Since their unitary returns resulted in lower tax payments than their separate returns, the taxpayers believed that they were entitled to refunds. The Cabinet adopted settlement guidelines for the taxpayers' return amendments and settled several refund claims. The Cabinet did not issue unitary tax assessments on its own to corporations that filed separate returns before December 22, 1994. The Cabinet also did not settle the Plaintiffs' claims for reasons set forth below.

While the Cabinet settled claims, the General Assembly passed H.B. 599 in 1996. This legislation

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[1] The Plaintiffs filed their amendments in different years, such as from April 1995 to April 1998, and for several different tax years, such as from 1987 to 1994. *See* Pl. Summary Judgment Br. at p.4.

prohibited the filing of unitary returns for tax years after December 31, 1995. The Cabinet could still process unitary returns for tax years prior to this date.

Two years later, the General Assembly barred refunds based on unitary returns filed after December 22, 1994, for tax years before December 31, 1995. H.B. 321, Section 33. Several parties challenged the prohibition, which was enacted in the General Assembly's 1998 Budget Bill. This Court invalidated the legislation, *see Elk River Res., Inc. v. Revenue Cabinet*, Civil Action No. 98-CI-1221 and 98-CI-1223, and the Court of Appeals dismissed the Cabinet's appeal, apparently due to mootness. During the appeal, H.B. 321 expired on its own terms in 2000 and the legislature enacted H.B. 541.

H.B. 541, enacted in 2000, prohibits two actions. The statute prohibits 1) refund claims based on unitary returns filed after December 22, 1994, for tax years on or before December 31, 1995, and 2) corporations from filing unitary returns for tax years ending before December 31, 1995, unless the corporations filed unitary returns on or before December 22, 1994, for tax years ending before December 22, 1994. KRS 141.200(9)-(10).[2]

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[2] KRS 141.200(9) states:

> No claim for refund or credit of a tax overpayment for any taxable year ending on or before December, 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a

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Although KRS 141.210(2) requires the Cabinet to audit tax returns "[a]s soon as practicable" after it receives returns, the Cabinet failed to settle the Plaintiffs' claims before the passage of H.B. 541. The legislation consequently eliminated the Plaintiffs' refund claims.

The Plaintiffs highlight the Cabinet's treatment of settling unitary returns filed before *GTE* to after H.B. 541. The Cabinet settled at least twenty unitary refund claims filed before *GTE* for tax years during Revenue Policy 41P225, though some of the claims were settled after *GTE*. These parties ignored Revenue Policy 41P225's ban on such returns. The Cabinet settled at least seven unitary refund claims filed after *GTE* and before H.B. 541. The Cabinet also settled at least one unitary refund claim after *GTE* and after H.B. 541 even though the legislation barred such settlements. About thirty taxpayers with unitary

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change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return, shall be effective or recognized for any purpose.

KRS 141.200(10) provides:

No corporation or group of corporations shall be allowed to file a combined return under the unitary business concept or a consolidated return for any taxable year ending before December 31, 1995, unless on or before December 22, 1994, the corporation or group of corporations filed an initial or amended return under the unitary business concept or consolidated return for a taxable year ending before December 22, 1994.

refund claims filed after *GTE* remained before H.B. 541's enactment, including six plaintiffs here.

The Cabinet began tracking actual and potential claimants and the amount of their claims by the end of 1995. At that time, the Cabinet estimated the claims to be worth about $50 million. In October 1996 the Cabinet estimated unpaid refund claims to be worth approximately $160 million. That figure rose to $177 million by April 1997 and to almost $200 million at the end of June 1998, with $65 million of that being interest. The Plaintiffs' claims are now worth over $200 million, which includes interest.

The Governor and the Generally [sic] Assembly were aware of potential claims as early as 1996. The Plaintiffs allege that the Cabinet represented to the General Assembly in March 2000 that the claims constituted "unanticipated revenue loss." The Plaintiffs further assert that the Cabinet neglected to inform the 2000 General Assembly that the largest refund claim, approximately $100 million, was settled before H.B. 541's enactment.

The Plaintiffs believe that the Cabinet and the General Assembly unlawfully prevented them from obtaining tax refunds. The Plaintiffs argue that the law requires the Cabinet to process their claims.[3]

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[3] The Cabinet apparently processed and denied the Plaintiffs' claims after this litigation began. The Plaintiffs assert that the Cabinet never raised H.B. 541 as a defense. *See* Pl. Reply to Comm. Resp. to Motion for Sum. Judg. at p.4.

Both parties present considerable arguments. For the reasons below, the Court grants summary judgment for the Defendants.

II. Discussion

A. Standard of Review

In order to succeed on a motion for summary judgment, the movant must meet the initial burden of establishing that no genuine issue of material fact exists and that the movant is entitled to judgment as a matter of law. CR 56.03. The record must be viewed in a light most favorable to the party opposing the motion for summary judgment and all doubts must be resolved in favor of that party. *Steelvest, Inc. v. Scansteel Serv. Ctr., Inc.*, Ky., 807 S.W.2d 476 (1991). "The inquiry should be whether, from the evidence of record, facts exist which would make it possible for the non-moving party to prevail. In the analysis, the focus should be on what is of record rather than what might be presented at trial." *Welch v. Am. Publ'g Co. of Ky.*, Ky., 3 S.W.3d 724, 730 (1999).

B. Due Process[4]

The Plaintiffs first argue that H.B. 541 violates their constitutional due process rights under *McKesson Corp. v. Div. of Alcoholic Beverages and Tobacco*, 496 U.S. 18 (1990), and *Revenue Cabinet v. Gossum*, Ky., 887 S.W.2d 329 (1994). By eliminating their refund claims, the Plaintiffs argue that H.B. 541 unconstitutionally deprives them of their post-deprivation (after payment of tax) procedural safeguards.

This argument, however, misses the mark. Without question, *McKesson* teaches that a state must provide an adequate post-deprivation remedy if a tax statute is ruled unconstitutional. But does the Due Process Clause require a post-deprivation remedy for overpaid taxes under a constitutional tax statute? The answer is: no. From a constitutional basis, there is no right to sue the state to recover overpaid taxes under a constitutional statute. "It is to be recognized 'that the right to a refund of illegally or improperly collected taxes does not derive from the common law, but is a matter of legislative grace.'" *Gossum*, 887 S.W.2d at 334 (quoting *Dep't. of Conservation v. Co-De Coal Co.*, Ky., 388 S.W.2d 614, 615 (1964).

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[4] The Defendants unconvincingly assert the defense of sovereign immunity. *See, e.g., Rose v. Council for Better Education, Inc.*, Ky., 790 S.W.2d 186, 209 (1989); *Marbury v. Madison*, 5 U.S. 137 (1803). As such, the Court examines the Plaintiffs' substantive claims.

It is important to keep in mind that the Plaintiffs paid their corporate income tax under the "separate return" method. The "unitary" method may generate a greater or lesser tax liability for the same corporate group depending upon many factors. If there is a tax overpayment under either method, KRS 134.580 provides for a refund of such overpayment. H.B. 541 does not amend or change this statute.

But this is not to say that the Plaintiffs have a constitutional right to select a particular method of accounting – *i.e.* "unitary" versus "separate – to determine their Kentucky income tax liability. The Plaintiffs have no property interest in tax laws. "Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code." *United States v. Carlton*, 512 U.S. 26, 33 (1994).

Without cavil, H.B. 541 retroactively prohibits the filing of unitary returns for pre-1995 years after December 22, 1994, unless the corporate group filed such a return on or before December 22, 1994.

The controlling Due Process Clause principles of retroactive tax legislation were announced in *United States v. Carlton*, *supra*. Under *Carlton*, the constitutional test applied to retroactive tax legislation is the rational basis test:

> The due process standard to be applied to tax statutes with retroactive effect . . . is the same as that generally applicable to retroactive economic legislation: "Provided that the retroactive application of a statute is

> supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches. . . . "'The retroactive aspects of legislation, as well as the prospective aspects, must meet the test of due process'. . . . But that burden is met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose."

512 U.S. at 30-31 (quoting *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 729-730 (1984) (quoting *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 16-17 (1976))).

The Cabinet asserts that the rational legislative basis for H.B. 541 is to avoid a massive loss of state revenue caused by use of unitary returns for pre-1995 years.

The Plaintiffs argue that they detrimentally relied on the Cabinet's interpretation of prior law that "separate returns" were required and that they should not be punished for this good faith reliance. But *Carlton* makes clear that such detrimental reliance does not result in a constitutional violation, finding that "[a]lthough Carlton's reliance is uncontested—and the reading of the original statute on which he relied appears to have been correct—his reliance alone is insufficient to establish a constitutional violation. Tax legislation is not a promise, and

a taxpayer has no vested right in the Internal Revenue Code." 512 U.S. at 33.

The Court holds that in this instance the rationale of *Carlton* applies in that the retroactive prohibition of unitary returns for the period in question meets the rational legislative purpose standard.

The Plaintiffs also argue that *Carlton* requires that the period of retroactivity be "modest" and that the period involved here is excessive.

The Court disagrees. The "modesty" requirement apparently derives from Justice O'Connor's concurring opinion in *Carlton*. But this is not the holding in *Carlton*. The majority uses language in the context of analyzing whether the economic legislation—which meets a legitimate legislative purpose—furthers that purpose by a "rational means." Here, that "rational means" is the retroactive application of tax legislation to correct the prior version of the statute to stem a massive revenue loss. As the *Carlton* Court holds: "[b]ecause we conclude that retroactive application of the amendment is rationally related to a legitimate state purpose, we conclude that the amendment is consistent with the Due Process Clause." *Carlton*, 512 U.S. at 35.

H.B. 541's period of retroactivity (at most 5.5 years) is not excessive in light of the legitimate governmental purpose it is designed to achieve—stemming the loss of massive revenues caused by the unitary method for corporate tax returns for pre-1995 years. This period comports with the holdings of

many federal court decisions considering retroactive tax legislation. *Milliken v. United States*, 283 U.S. 15 (1931); *Mont. Rail Link, Inc. v. United States*, 76 F.3d 991 (9th Cir. 1996); *Tate & Lyle, Inc. v. Comm'r*, 87 F.3d 99 (3d Cir. 1996); *Honeywell, Inc. v. United States*, 973 F.2d 638 (8th Cir. 1992); *Rutter v. Comm'r*, 760 F.2d 466 (2d Cir. 1985); *Licari v. Comm'r of Internal Revenue*, 946 F.2d 690 (9th Cir. 1991); *Wilgard Realty Co. v. CIR*, 127 F.2d 514 (2d Cir.), *cert. denied*, 317 U.S. 655 (1942); *A. Tarricone, Inc. v. United States*, 4 F. Supp. 323 (S.D.N.Y. 1998); *Fife v. CIR*, 82 T.C.1, 13 (1984).

C. Equal Protection

As with constitutional due process, equal protection examination of tax issues begins with the query: is the statute a rational means of promoting a legitimate state objective? As stated in *Yeoman v. Commonwealth Health Policy Bd.*, Ky., 983 S.W.2d 459, 470 (1998), a tax statute

> need only be tested under the lenient standard of rationality . . . Under that standard, a statute will be sustained if the legislature could have reasonably concluded that the challenged classification would promote a legitimate state purpose . . . Legislation will be upheld under equal protection principles of the federal and state constitutions if the law is rationally related to a legitimate state objective.

This test applies whether the tax is prospective or retroactive. *See Welch v. Henry*, 305 U.S. 134 (1938).

The Plaintiffs argue that H.B. 541 treats them differently from other "unitary" corporate taxpayers and thus violates the Equal Protection Clause. But *Yeoman* dispels this argument:

> Appellants argue that it is irrational and arbitrary to tax one sub-group of health care providers and not another. We do not find this argument compelling. The rational review standard . . . merely requires one to postulate that the legislature could have envisioned that [the statute] would promote a legitimate state purpose – any legitimate state purpose. Appellants' argument is essentially that this tax is unfair and therefore unconstitutional. This is not the correct standard.

Yeoman, 983 S.W.2d at 470.

Revenue argues that avoiding a loss of tax revenue is a "legitimate state purpose" and that KRS 141.200(1) [sic] is a "rational means" to achieve that purpose. The General Assembly has lawfully concluded, argues Revenue, that prohibiting the use of the "unitary" corporate tax returns after December 22, 1994, meets this objective. The legislation sets an "effective" date and simply treats "similarly situated taxpayers" differently on either side of this date. Such a legislative act does not violate Equal Protection Clause principles.

Is this different treatment of "similarly situated" taxpayers rationally related to a legitimate state objective? Again, that objective is the avoidance of loss of state tax revenues. The General Assembly must have concluded in its 2000 Session that prohibiting the use of "unitary" corporate tax returns filed after December 22, 1994, for pre-1995 tax years would meet this objective.

Nor does the fact that H.B. 541 acts retroactively run afoul of the Equal Protection Clause. *Welch v. Henry*, 305 U.S. 134 (1938); *United States v. Darusmont*, 449 U.S. 292 (1981); *United States v. Hemme*, 476 U.S. 558 (1986). And under *Carlton*, we learn that "[r]evenue raising is certainly a legitimate legislative purpose, and any law that retroactively adds a tax, removes a deduction, or increases a rate, *rationally* furthers that goal." 512 U.S. at 40 (emphasis added).

Further, legislation taxing "similarly situated" taxpayers differently, based on the effective date of the legislation, is a rational means of accomplishing the legitimate public purpose of avoiding the loss of tax revenue. *Ky. Bd. of Tax Appeals v. Citizens Fidelity Bank*, Ky., 525 S.W.2d 68 (1975); *Licari v. Comm'r of Internal Revenue*, 946 F.2d 690 (9th Cir. 1991). In short, the Plaintiffs' equal protection arguments are without merit.

D. Special Legislation

The Plaintiffs unpersuasively contend that H.B. 541 is special legislation prohibited by Section 59 of the Kentucky Constitution. Section 59 states that "[t]he General Assembly shall not pass local or special acts concerning any of the following subjects, or for any of the following purposes, namely . . . (15) To authorize or regulate the levy, assessment or collection of taxes." To satisfy Section 59, "(1) [the legislation] must apply equally to all in a class, and (2) there must be distinctive and natural reasons inducing and supporting the classification." *Schoo v. Rose*, Ky., 270 S.W.2d 940, 941 (1954). *Yeoman v. Com. Health Policy Bd.*, Ky., 983 S.W.2d 459, 466 (1998). This test, or at least the second prong, is virtually the same as the rational basis test. *See Temperance League of Ky. v. Perry*, Ky., 74 S.W.3d 730, 733-34 (2002) (second *Schoo* element fulfilled if "the classification set forth in the statute is reasonably related to" the legislative purpose).

H.B. 541 passes the *Schoo* test and is therefore constitutional under Section 59. Under the first prong of the test, H.B. 541(1)(10) (codified as KRS 141.200(10)) applies equally to all corporations seeking to file pre-1995 "unitary" or "combined" tax returns after December 22, 1994, and it applies equally to all corporations that filed their pre-1995 "unitary" or "combined" tax returns on or before December 22, 1994. The legislation prohibits the filing in the former class, and it allows the filing in the latter class.

The legislation similarly passes the second prong of the *Schoo* test. The classification is based on whether a corporation filed its pre-1995 "unitary" or "combined" tax return before, on, or after December 22, 1994. The legislative purpose for the classification is to prevent the massive loss of state revenue. The legislation is "reasonably related" to this purpose because it prohibits the filing of "unitary" or "combined" tax returns filed after December 22, 1994. *See Perry*, 74 S.W.3d at 733-34. If the legislature allowed filings after this date, the state would suffer a tremendous revenue loss, whereas the state would not suffer such a loss by allowing the filings on or before this date. Since a "valid nexus between the classification" and the legislation's purpose exists, the legislation is constitutional under Section 59. *Yeoman*, 983 S.W.2d at 468.

E. Sections 2 and 3 of the Kentucky Constitution

The Plaintiffs argue that H.B. 541 contravenes Sections 2 and 3 of the Kentucky Constitution. The Plaintiffs acknowledge that both sections "embrace the traditional concepts of both due process of law and equal protection of law." (Pl. Br. at 41) (citing *Ky. Milk Mktg. & Antimonopoly Com. v. Kroger Co.*, 691 S.W.2d 893 (1985)). The Court finds no significant difference between the Plaintiffs' federal constitutional claims and the Plaintiffs' arguments under Sections 2 and 3 of the Kentucky Constitution. Since

the Court found that the former lack merit, the Court holds that the latter are without foundation as well.

F. Takings Clause

The Plaintiffs contend that H.B. 541 violates the takings clauses in the federal and Kentucky constitutions. Both clauses prohibit the taking of private property for public use without just compensation. U.S. Const. Amend V; Kentucky Const. Section 13.

No authority supports the Plaintiffs' contention. The Plaintiffs cite no case for the proposition that tax legislation that retroactively eliminates a category of tax returns is a taking. The Plaintiffs rely on *Eastern Enters v. Apfel*, 524 U.S. 498 (1998), where the Court declared the 1992 Coal Act unconstitutional. The Act required a former coal operator to fund health benefits for miners who worked in the mines before 1966. Although the Court found that the Act violated substantive due process, a majority of the Court did not find a taking violation. The majority "rejected the idea that a law that imposed only a financial burden without identifying a particular property right could ever constitute a taking." *Unity Real Estate Co. v. Hudson*, 178 F.3d 649, 674 (3d Cir. 1999). *Accord Parella v. Ret. Bd. of R.I. Ret. Sys.*, 173 F.3d 46, 58 (1st Cir. 1999). Here, the Plaintiffs fail to identify a "particular property right," and case law holds that taxpayers do not have property rights in the tax code. *Carlton*, 512 U.S. at 33. *Apfel*, in short, does not aid the Plaintiffs.

G. Separation of Powers

Finally, the Plaintiffs maintain that H.B. 541 invades the power of the judicial and executive branches in violation of the separation of powers doctrine in Sections 27 and 28 of the Kentucky Constitution.

The Court finds otherwise, however. H.B. 541 does not encroach on the judiciary because H.B. 541 does not, as the Plaintiffs' claim, affect the judgment of *GTE v. Revenue Cabinet*, Ky., 889 S.W.2d 788 (1994). H.B. 541, which amends the statutory structure analyzed in *GTE*, states that it takes effect after the date of the *GTE* decision. *See Telemarketing* [sic] *Communications, Inc. v. Liberty Partners*, Ky., 798 S.W.2d 462 (1990). H.B. 541 also does not intrude on the executive branch because "[t]he General Assembly has the basic constitutional power and responsibility to tax and spend the public's money. This power is exclusive to the General Assembly." *Armstrong v. Collins*, Ky., 709 S.W.2d 437, 448 (1986). Since the legislature has the sole power to tax, it did not tread on an executive function by amending a tax statute in H.B. 541.

III. Conclusion

ACCORDINGLY, the Court OVERRULES the Plaintiffs' Motion for Summary Judgment and GRANTS the Defendants' Motion for Summary Judgment.

This is a final and appealable Order and there is no just cause for delay.

SO ORDERED, this 1 day of July, 2004.

/s/ William L. Graham
WILLIAM L. GRAHAM,
JUDGE
FRANKLIN CIRCUIT COURT
DIVISION II

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Supreme Court of Kentucky

2006-SC-000416-DG
2007-SC-000819-DG

JONATHAN MILLER, SECRETARY OF THE FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY; COMMONWEALTH OF KENTUCKY, DEPARTMENT OF REVENUE

APPELLANTS/CROSS-APPELLEES

V. ON REVIEW FROM COURT OF APPEALS
CASE NO. 2004-CA-001566-MR
FRANKLIN CIRCUIT COURT
NOS. 00-CI-00523 AND 00-CI-00661

JOHNSON CONTROLS, INC.; SECURITY GROUP, INC. AND SUBSIDIARIES, INCLUDING SARGENT & GREENLEAF, INC.; WILLIS NORTH AMERICA, INC. AND AFFILIATES; BUNZL USA, INC. AND SUBSIDIARIES INCLUDING MAK-PAK, INC.; TREDEGAR CORPORATION, INC. AND SUBSIDIARIES; COSMOS BROADCASTING CORPORATION AND AFFILIATES

APPELLEES/ CROSS-APPELLANTS

ORDER

The Petition for Rehearing, filed by the Appellee/ Cross-Appellant, of the Opinion of the Court, rendered August 27, 2009, is hereby DENIED.

Cunningham, Noble, Schroder, Scott and Venters, JJ., concur. Abramson, J., would have granted. Minton, C.J.; not sitting.

ENTERED: November 25, 2009

/s/ Will T. Scott
DEPUTY CHIEF JUSTICE

CHAPTER 543

(HB 541)

AN ACT relating to corporate income tax and declaring an emergency.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 141.200 is amended to read as follows:

* * *

(7) For any taxable year ending on or after December 31, 1995, except as provided under subsection (3) of this section, nothing in this chapter shall be construed as allowing or requiring the filing of:

(a) A combined return under the unitary business concept; or

(b) A consolidated return.

(8) No assessment of additional tax due for any taxable year ending on or before December 31, 1995, made after December 22, 1994, and based on requiring a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return, shall be effective or recognized for any purpose.

(9) No claim for refund or credit of a tax overpayment for any taxable year ending on or before December, 31, 1995, made by an

amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return, shall be effective or recognized for any purpose.

(10) No corporation or group of corporations shall be allowed to file a combined return under the unitary business concept or a consolidated return for any taxable year ending before December 31, 1995, unless on or before December 22, 1994, the corporation or group of corporations filed an initial or amended return under the unitary business concept or consolidated return for a taxable year ending before December 22, 1994.

(11) This section shall not be construed to limit or otherwise impair the cabinet's authority under KRS 141.205.

* * *

Section 3. The provisions of subsection (7) of Section 1 of this Act shall apply retroactively for taxable years ending on or after December 31, 1995. The provisions of subsections (8) to (11) of Section 1 of this Act shall apply retroactively for all taxable years ending before December 31, 1995.

Section 4. Whereas the fiscal year begins on July 1 and the General Assembly finds that it is critical that this Act take effect at the beginning of

the fiscal year, an emergency is declared to exist, and this Act takes effect July 1, 2000.

Approved April 26, 2000